

Internal Revenue bulletin

Bulletin No. 2001-11
March 12, 2001

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2001-12, page 811.

Federal rates; adjusted federal rates; adjusted federal long-term rate; and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for March 2001.

T.D. 8927, page 807.

Final regulations under section 985 of the Code relate to U.S. taxpayers operating, investing, or otherwise conducting business in the currencies of certain European countries that replace their national currencies with a single, multinational currency called the euro. These regulations provide rules relating to adjustments required for qualified business units operating in such currencies and rules relating to the tax effect of holding such currencies, or financial instruments or contracts denominated in such currencies.

T.D. 8932, page 813.

Final regulations under section 7502 of the Code extend the timely-mailing-treated-as-timely-filing rule to electronically filed documents. The regulations also provide that under certain circumstances a claim for credit or refund made on a late-filed original tax return will be treated as filed on the postmark date for purposes of determining the timeliness of the claim.

T.D. 8933, page 794.

Final regulations under section 132(f) of the Code provide guidance on qualified transportation fringe benefits (van-pooling, transit passes, and qualified parking) provided by employers to their employees. Notice 94-3 modified. Announcement 2000-78 obsolete.

T.D. 8937, page 806.

Final regulations under section 367(b) of the Code address distributions with respect to, or a disposition of, certain stock that was subject to prior temporary regulations under section 367(b).

REG-106030-98, page 820.

Proposed regulations under sections 863(a), (d), and (e) of the Code provide rules for sourcing income of U.S. and foreign persons from space and ocean activity and from communications activity. A public hearing is scheduled for March 28, 2001.

Notice 2001-21, page 818.

Low-income housing tax credit. This notice reproduces the proper population figures to be used for determining the 2001 calendar year population-based component of the state housing credit ceiling under section 42(h) of the Code and the 2001 calendar year volume cap under section 146 of the Code.

Announcement 2001-26, page 896.

This document contains corrections to final regulations (T.D. 8913, 2001-3 I.R.B. 300) providing guidance on recognition of gain on certain distributions of stock or securities.

EMPLOYEE PLANS

REG-130477-00 and REG-130481-00, page 865.

Proposed regulations under sections 457 and 403(b) of the Code provide comprehensive rules for determining required minimum distributions for qualified plans, tax-sheltered annuities, and individual retirement plans. This is the corrected

(Continued on the next page)

Finding Lists begin on page ii.



Department of the Treasury
Internal Revenue Service

version of the proposed regulations published in the Federal Register on January 17, 2001. A public hearing is scheduled for June 1, 2001.

Notice 2001-20, page 818.

Weighted average interest rate update. The weighted average interest rate for February 2001 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

ESTATE AND GIFT TAXES

Announcement 2001-22, page 895.

Advance valuation of art. This announcement informs taxpayers who wish to request from the Service a Statement of Value under Rev. Proc. 96-15, 1996-1 C.B. 627, for use in substantiating the value of art for income, estate, and gift tax purposes of a change of address for submission of such requests. Rev. Proc. 96-15 modified.

ADMINISTRATIVE

REG-111835-99, page 834.

Proposed regulations relate to practice before the Internal Revenue Service (Circular 230). These regulations would affect individuals who are eligible to practice before the Service. The proposed modifications would clarify the gen-

eral standards of practice before the Service and would modify the standards for providing advice regarding tax shelters. A public hearing is scheduled for May 2, 2001.

REG-126100-00, page 862.

Guidance is provided on the reporting requirements for interest on deposits maintained at the U.S. office of certain financial institutions and paid to nonresident alien individuals. These proposed regulations affect persons making payments of interest with respect to such a deposit. A public hearing is scheduled for March 21, 2001.

Announcement 2001-22, page 895.

Advance valuation of art. This announcement informs taxpayers who wish to request from the Service a Statement of Value under Rev. Proc. 96-15, 1996-1 C.B. 627, for use in substantiating the value of art for income, estate, and gift tax purposes of a change of address for submission of such requests. Rev. Proc. 96-15 modified.

Announcement 2001-25, page 895.

This document contains corrections to Rev. Proc. 2001-3, 2001-1 I.R.B. 111, relating to issues on which the Service will not issue letter rulings or determination letters.

Announcement 2001-27, page 897.

Proposed regulations (REG-116048-99, 2000-6 I.R.B. 584) that relate to an election available to certain taxpayers under section 367(b) of the Code are withdrawn. The withdrawal corresponds to the upcoming expiration of the availability of the election.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities

and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and proce-

dures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2001. See Rev. Rul. 2001-12, page 811.

Section 132.—Certain Fringe Benefits

26 CFR 1.132-9: *Qualified transportation fringes.*

T.D. 8933

DEPARTMENT OF THE TREASURY Internal Revenue Service (IRS) 26 CFR Parts 1 and 602

Qualified Transportation Fringe Benefits

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations relating to qualified transportation fringe benefits. These final regulations provide rules to ensure that transportation benefits provided to employees are excludable from gross income. These final regulations reflect changes to the law made by the Energy Policy Act of 1992, the Taxpayer Relief Act of 1997, and the Transportation Equity Act for the 21st Century. These final regulations affect employers that offer qualified transportation fringes and employees who receive these benefits.

DATES: *Effective Date:* These regulations are effective January 11, 2001.

Applicability Date: For dates of applicability, see §1.132-9(b), Q/A-25.

FOR FURTHER INFORMATION CONTACT: John Richards, (202) 622-6040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of

1995 (44 U.S.C. 3507) under control number 1545-1676. Responses to this collection of information are mandatory to obtain the benefit described under section 132(f).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

The estimated average annual record-keeping burden per recordkeeper is 26.5 hours. The estimated annual reporting burden per respondent is .8 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S:O, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long as their contents might become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to 26 CFR part 1 (Income Tax Regulations). On January 27, 2000, a proposed regulation (REG-113572-99, 2000-7 I.R.B. 624) relating to qualified transportation fringes was published in the **Federal Register** (65 FR 4388). A public hearing was held on June 1, 2000. Written or electronic comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed below.

Explanation of Provisions and Summary of Comments

In general, comments received on the proposed regulations were favorable and, accordingly, the final regulations retain the general structure of the proposed reg-

ulations, including the question and answer format and a variety of examples illustrating the substance of the final regulations. However, commentators made a number of specific recommendations for modifications and clarifications of the regulations. In response to these comments, the final regulations incorporate the modifications and clarifications described below.

A. *Whether Vouchers are Readily Available*

Section 132(f)(3) provides that qualified transportation fringes include cash reimbursement for transit passes “only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.” Thus, if vouchers are readily available, the employer must use vouchers and cash reimbursement of a mass transit expense would not be a qualified transportation fringe.

Most of the comments received addressed the issue of whether vouchers are “readily available.” Commentators representing employers generally favored rules permitting cash reimbursement. Commentators representing transit operators and voucher providers generally favored rules not permitting cash reimbursement. The following discusses three issues raised by commentators: first, whether the proposed regulations’ 1 percent safe harbor should be retained; second, whether internal administrative costs should be considered in applying the 1 percent test; and third, whether other non-financial restrictions should be considered in determining whether vouchers are readily available.

1. *The 1 percent safe harbor*

Under Notice 94-3, 1994-1 C.B. 327, and the proposed regulations, a voucher is readily available if an employer can obtain it on terms no less favorable than those available to an individual employee and without incurring a significant administrative cost. Under the proposed regulations, administrative costs relate only to fees paid to fare media providers, and the determination of whether obtaining a

voucher would result in a significant administrative cost is made with respect to each transit system voucher. The proposed regulations provide a rule under which administrative costs are treated as significant if the average monthly administrative costs incurred by the employer for a voucher (disregarding delivery charges imposed by the fare media provider to the extent not in excess of \$15 per order) are more than 1 percent of the average monthly value of the vouchers for a system.

Commentators, in particular those representing fare media providers and transit operators, suggested that the fare media provider fee percentage causing vouchers to not be readily available should be raised because many fare media providers charge fees in excess of the 1 percent limit and, thus, under this test, transit vouchers would not be considered readily available in some large metropolitan areas. These commentators assert that the 1 percent test is therefore contrary to the intent of the statute. Commentators suggested that the 1 percent test, particularly if combined with inadequate cash reimbursement substantiation requirements, may result in taxpayer abuse, with the result that the benefit might not be used for the purpose for which it is intended, which is to increase the use of mass transit. In addition, commentators testified at the public hearing that the mandatory use of vouchers (with no ability to use cash reimbursement if vouchers are readily available) would increase the use of vouchers and promote the development of advanced technologies that minimize the burden on employers while ensuring that the benefit is used for mass transit. These new technologies might allow an employer to make payment directly to the transit operator, who in turn credits fare to the employee's magnetic media fare card, thus eliminating the need for employers to incur the expense of distributing vouchers.

Other commentators, in particular groups representing employers, generally favored the 1 percent test, but suggested that internal costs be considered in applying the test (discussed below). These commentators took the position that an increase in the percentage might affect the market charge for such services. There was also a concern that a strict voucher-

use requirement would result in fewer employers adopting transit pass programs, thus frustrating the purpose of section 132(f) to increase the use of mass transit.

The final regulations retain the 1 percent test. The 1 percent test, applicable for years beginning after December 31, 2003, is appropriate in light of the rule (discussed below) that only voucher provider fees are considered in determining availability. It is intended that the delayed application of this rule would provide sufficient time for those affected by this rule to modify their systems and procedures appropriately. The 1 percent threshold, coupled with the exclusion of internal administrative costs from the readily available determination, represents a balanced approach that will promote the growth of voucher programs in most transportation areas. In addition, raising the percentage threshold could curtail the growth in transit benefit programs, which would be contrary to the goal of increasing the use of mass transit. Finally, in cases where cash reimbursement is allowed, adequate substantiation requirements will ensure that transit pass benefits will actually go toward mass transportation usage. In this regard, the proposed regulations provide that employers must implement reasonable procedures to ensure that an amount equal to the reimbursement was incurred for transit passes. For example, the final regulations clarify that in circumstances when employee certification is a reasonable reimbursement procedure, it must occur after the expense is incurred.

The final regulations also clarify the application of the 1 percent rule if multiple vouchers for a transit system are available for distribution by an employer to employees, and if multiple transit system vouchers are required in an area to meet the transit needs of an employer's employees. The final regulations provide that if multiple transit system vouchers are available for direct distribution to employees, the employer must consider the lowest cost voucher for purposes of determining whether the voucher provider fees cause vouchers to not be readily available. However, if multiple vouchers are required in an area to meet the transit needs of the individual employees in that area, the employer has the option of averaging the costs applied to vouchers from

each system for purposes of determining whether the voucher provider fees cause vouchers to not be readily available.

2. Internal administrative costs

Several commentators representing employers recommended that, in addition to fare media provider fees, internal administrative costs, especially security and distribution costs, should be considered in determining whether vouchers are readily available. These commentators noted that administrative costs are increased when an employer must maintain both a voucher system and a reimbursement system to provide qualified transportation fringes. For example, the employer may maintain a cash reimbursement system for transportation in a commuter highway vehicle and qualified parking, and also maintain a voucher system for transit passes. In addition, several commentators suggested that the increased costs and administrative burden for employers that maintain offices in multiple cities should also be considered in determining whether vouchers are readily available.

The final regulations retain the test considering only fees paid to voucher providers in determining availability based on a plain reading of the terms of the statute. The language "readily available for direct distribution by the employer to the employee" under section 132(f)(3) in its plain, ordinary sense means that vouchers are easily obtainable for direct distribution to the employer's employees. The determination of availability bears no relationship with costs that may be incurred after vouchers have been obtained. The service fees charged by voucher providers and delivery costs can reasonably be viewed as affecting whether vouchers are easily obtainable; an employer's internal costs of subsequently administering a voucher program would not. Thus, based upon the plain language of section 132(f), internal administrative costs do not affect whether vouchers are readily available.

Moreover, the test considering only voucher provider fees is a comparatively simple bright line test. A test that depends on the employer's internal administrative costs would necessarily be complex, requiring complex rules that would be difficult for employers to apply.

3. *Other nonfinancial restrictions*

Commentators representing employers suggested that nonfinancial factors should be considered in determining whether vouchers are readily available. They suggested that factors such as whether there are reasonable advance purchase and minimum purchase requirements, and whether vouchers can be purchased in appropriate denominations, should be considered in determining availability. The final regulations adopt this suggestion because nonfinancial restrictions would reasonably affect whether vouchers are available for distribution by an employer to an employee.

The final regulations provide guidance on the types of nonfinancial restrictions that cause vouchers to not be readily available. The final regulations provide that certain nonfinancial restrictions, such as a voucher provider not making vouchers available for purchase at reasonable intervals or failing to provide the vouchers within a reasonable period after receiving payment for the voucher, cause vouchers to not be readily available. In addition, if a voucher provider does not provide vouchers in reasonably appropriate quantities, or in reasonably appropriate denominations, vouchers may not be readily available.

When and as the standards in these final regulations go into effect, they will supersede the current law standards in Notice 94-3.

B. *Advance Transit Passes*

Commentators suggested that the administrability of transit pass programs would be improved if vouchers were permitted to be distributed in advance for more than one month. The final regulations adopt this suggestion.

In October of this year, the IRS issued Announcement 2000-78 (2000-43 I.R.B. 428) to notify taxpayers that, when finalized, the regulations will clarify that transit passes may be distributed in advance for more than one month (such as for a calendar quarter) by taking into account the monthly limits for all months for which the transit passes are distributed. The announcement further provides, however, that if an employee receives advance transit passes, and the employee's

employment terminates before the beginning of the last month of the period for which the transit passes were provided, the employer must include in the employee's wages, for income and for employment tax purposes (FICA, FUTA, and income tax withholding), the value of the passes provided for those month(s) beginning after the employee's employment terminates to the extent the employer does not recover those transit passes or the value of those passes. The announcement provides that pending the issuance of these final regulations, employers may rely on the announcement.

The final regulations differ from the announcement in one respect. In any case in which transit passes are provided in advance for a period of no more than three months (such as for a calendar quarter), but the recipient ceases to be an employee before the beginning of the last month in that period, the final regulations provide that the value of a transit pass provided in advance for a month is excluded from wages for employment tax (FICA, FUTA, and income tax withholding) purposes (but not for income tax purposes) unless at the time the transit passes were distributed there was an established termination date that was before the beginning of the last month of that period and the employee does in fact terminate employment before the beginning of the last month of that period.

C. *Qualified Parking*

The final regulations address whether reimbursement paid to an employee for parking at a work location away from the employee's permanent work location is excludable from wages for income and employment tax purposes under section 132(f). Section 132(f)(5)(C) defines qualified parking, in part, as "parking provided to an employee on or near the business premises of the employer . . ." The final regulations provide that qualified parking includes parking on or near a work location at which the employee performs services for the employer. However, qualified parking does not include reimbursement for parking that is otherwise excludable from gross income as a reimbursement treated as paid under an accountable plan under §1.62-2 of the Income Tax Regulations, or parking pro-

vided in kind to an employee that is excludable from the employee's gross income as a working condition fringe under section 132(a)(3). Thus, if the exclusion at §1.62-2 or section 132(a)(3) is available (even if not reimbursed by the employer), then section 132(f) does not apply.

Whether a reimbursement for local transportation expenses, including parking at a work location away from the employee's permanent work location, is excludable from the employee's gross income under §1.62-2, or whether parking provided in kind to an employee is excludable from the employee's gross income under section 132(a)(3), is determined based upon whether the parking expenses would be deductible if paid or incurred by the employee under section 162(a) as an expense incurred in the employee's trade or business of being an employee for the employer. §§1.62-2(d); 1.132-5(a)(2). Revenue Ruling 99-7 (1999-1 C.B. 361) addresses under what circumstances daily transportation expenses, including parking, incurred by a taxpayer in going between the taxpayer's residence and a work location are deductible by the taxpayer under section 162(a).

The final regulations provide the minimum requirements to ensure that transportation benefits are qualified transportation fringes under section 132(f). An employer may have a transit benefit program that is more restrictive than a program meeting the minimum requirements under the regulations. In addition, these regulations do not affect the application of authorities outside the Internal Revenue Code which may restrict a transportation benefit program. Federal Government agencies, for example, may be required by other federal law to implement restrictions beyond those required under these regulations.

D. *Applicability Date*

The regulations are generally applicable for taxable years beginning after December 31, 2001. However, in order to provide a transition period for those affected by the 1 percent rule (described under "The 1 percent safe harbor" in this preamble), that rule is applicable for taxable years beginning after December 31, 2003.

Effect on Other Documents

The following document is obsolete as of January 11, 2001:
Announcement 2000-78 (2000-43 I.R.B. 428).

The following document is modified as of the date these regulations become applicable (see Q/A-25):
Notice 94-3 (1994-1 C.B. 327).

Special Analyses

It has been determined that this Treasury Decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. A final regulatory flexibility analysis has been prepared for the collection of information in this Treasury decision under 5 U.S.C. 604. A summary of the analysis is set forth in this preamble under the heading "Summary of Final Regulatory Flexibility Analysis."

Summary of Final Regulatory Flexibility Analysis

This analysis is required under the Regulatory Flexibility Act (5 U.S.C. chapter 6). The collection of information under this rule is based upon the requirements under section 132(f). We estimate that approximately 265,000 employers that provide qualified transportation fringes to their employees will be affected by the recordkeeping requirements of this rule. None of the comments received in response to the notice of proposed rule-making specifically addressed the initial regulatory flexibility analysis.

Section 132(f)(3) provides that qualified transportation fringes may be provided in the form of cash reimbursement. The legislative history indicates that an employer providing cash reimbursement to the employer's employees for qualified transportation fringes must establish a *bona fide* reimbursement arrangement. As a condition to providing cash reimbursement for qualified transportation fringes, this rule provides that employers must receive substantiation from employees. The objective of this rule is to ensure that reimbursements are made for qualified transportation fringes.

Whether an arrangement constitutes a *bona fide* reimbursement arrangement varies depending on the facts and circumstances, including the method or methods of payment utilized within a mass transit system. An employee certification in either written or electronic form may be sufficient depending upon the facts and circumstances. For example, if receipts are not provided in the ordinary course of business, such as with respect to metered parking or used transit passes that cannot be returned to the user, an employee certification that expenses have been incurred constitutes a reasonable reimbursement procedure. A certification that expenses will be incurred in the future, by itself, is not a reasonable reimbursement procedure. There are no particular professional skills required to maintain these records.

In addition, section 132(f)(4) provides that an employee may choose between cash compensation and qualified transportation fringes. This rule provides that an employer may allow an employee the choice to receive either a fixed amount of cash compensation at a specified future date or a fixed amount of qualified transportation fringes to be provided for a specified future period (such as qualified parking to be used during a future calendar month). This rule provides that employers must keep records with respect to employee compensation reduction elections. An employee's election must be in writing or some other permanent and verifiable form, and include the date of the election, the amount of compensation to be reduced, and the period for which the qualified transportation fringes will be provided. The objective of this rule is to ensure against recharacterization of taxable compensation after it has been paid to the employee. There are no particular professional skills required to maintain these records.

A less burdensome alternative for small organizations would be to exempt those entities from the recordkeeping requirements under this rule. However, it would be inconsistent with the statutory provisions and legislative history to exempt those entities from the recordkeeping requirements imposed under this rule.

This rule provides several options which avoid more burdensome recordkeeping requirements for small entities.

This rule provides that (1) there are no substantiation requirements if the employer distributes transit passes in kind; (2) a compensation reduction election may be made electronically; (3) an election to reduce compensation may be automatically renewed; (4) an employer may provide for deemed compensation reduction elections under its qualified transportation fringe benefit plan; and (5) a requirement that a voucher be distributed in-kind by the employer is satisfied if the voucher is distributed by the employer or by another person on behalf of the employer (for example, if a transit operator credits amounts to the employee's fare card as a result of payments made to the operator by the employer).

Drafting Information

The principal author of these regulations is John Richards, Office of the Assistant Chief Counsel (Exempt Organizations/Employment Tax/Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART I—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.132-0 is amended by:

1. Adding an entry for §1.132-5(p)(4)
2. Adding entries for §1.132-9.

The additions read as follows:

§1.132-0 Outline of regulations under section 132.

* * * * *

§1.132-5 Working condition fringes.

* * * * *

(p) * * *

(4) Dates of applicability.

* * * * *

§1.132-9 Qualified transportation fringes.

(a) Table of contents.

(b) Questions and answers.

Par. 3. Section 1.132-5 is amended by adding paragraph (p)(4) to read as follows:

§1.132-5 Working condition fringes.

* * * * *

(p) * * *

(4) *Dates of applicability.* This paragraph (p) applies to benefits provided before January 1, 1993. For benefits provided after December 31, 1992, see §1.132-9.

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Par. 4. Section 1.132-9 is added to read as follows:

§1.132-9 Qualified transportation fringes.

(a) *Table of contents.* This section contains a list of the questions and answers in §1.132-9.

(1) *General rules.*

Q-1. What is a qualified transportation fringe?

Q-2. What is transportation in a commuter highway vehicle?

Q-3. What are transit passes?

Q-4. What is qualified parking?

Q-5. May qualified transportation fringes be provided to individuals who are not employees?

Q-6. Must a qualified transportation fringe benefit plan be in writing?

(2) *Dollar limitations.*

Q-7. Is there a limit on the value of qualified transportation fringes that may be excluded from an employee's gross income?

Q-8. What amount is includible in an employee's wages for income and employment tax purposes if the value of the qualified transportation fringe exceeds the applicable statutory monthly limit?

Q-9. Are excludable qualified transportation fringes calculated on a monthly basis?

Q-10. May an employee receive qualified transportation fringes from more than one employer?

(3) *Compensation reduction.*

Q-11. May qualified transportation fringes be provided to employees pur-

suant to a compensation reduction agreement?

Q-12. What is a compensation reduction election for purposes of section 132(f)?

Q-13. Is there a limit to the amount of the compensation reduction?

Q-14. When must the employee have made a compensation reduction election and under what circumstances may the amount be paid in cash to the employee?

Q-15. May an employee whose qualified transportation fringe costs are less than the employee's compensation reduction carry over this excess amount to subsequent periods?

(4) *Expense reimbursements.*

Q-16. How does section 132(f) apply to expense reimbursements?

Q-17. May an employer provide nontaxable cash reimbursement under section 132(f) for periods longer than one month?

Q-18. What are the substantiation requirements if an employer distributes transit passes?

Q-19. May an employer choose to impose substantiation requirements in addition to those described in this regulation?

(5) *Special rules for parking and vanpools.*

Q-20. How is the value of parking determined?

Q-21. How do the qualified transportation fringe rules apply to van pools?

(6) *Reporting and employment taxes.*

Q-22. What are the reporting and employment tax requirements for qualified transportation fringes?

(7) *Interaction with other fringe benefits.*

Q-23. How does section 132(f) interact with other fringe benefit rules?

(8) *Application to individuals who are not employees.*

Q-24. May qualified transportation fringes be provided to individuals who are partners, 2-percent shareholders of S-corporations, or independent contractors?

(9) *Effective date.*

Q-25. What is the effective date of this section?

(b) *Questions and answers.*

Q-1. What is a qualified transportation fringe?

A-1. (a) The following benefits are qualified transportation fringe benefits:

(1) Transportation in a commuter highway vehicle.

(2) Transit passes.

(3) Qualified parking.

(b) An employer may simultaneously provide an employee with any one or more of these three benefits.

Q-2. What is transportation in a commuter highway vehicle?

A-2. Transportation in a commuter highway vehicle is transportation provided by an employer to an employee in connection with travel between the employee's residence and place of employment. A commuter highway vehicle is a highway vehicle with a seating capacity of at least 6 adults (excluding the driver) and with respect to which at least 80 percent of the vehicle's mileage for a year is reasonably expected to be—

(a) For transporting employees in connection with travel between their residences and their place of employment; and

(b) On trips during which the number of employees transported for commuting is at least one-half of the adult seating capacity of the vehicle (excluding the driver).

Q-3. What are transit passes?

A-3. A transit pass is any pass, token, farecard, voucher, or similar item (including an item exchangeable for fare media) that entitles a person to transportation—

(a) On mass transit facilities (whether or not publicly owned); or

(b) Provided by any person in the business of transporting persons for compensation or hire in a highway vehicle with a seating capacity of at least 6 adults (excluding the driver).

Q-4. What is qualified parking?

A-4. (a) Qualified parking is parking provided to an employee by an employer—

(1) On or near the employer's business premises; or

(2) At a location from which the employee commutes to work (including commuting by carpool, commuter highway vehicle, mass transit facilities, or transportation provided by any person in the business of transporting persons for compensation or hire).

(b) For purposes of section 132(f), parking on or near the employer's business premises includes parking on or near a work location at which the employee provides services for the employer. However, qualified parking does not include—

(1) The value of parking provided to an employee that is excludable from gross income under section 132(a)(3) (as a working condition fringe), or

(2) Reimbursement paid to an employee for parking costs that is excludable from gross income as an amount treated as paid under an accountable plan. See §1.62-2.

(c) However, parking on or near property used by the employee for residential purposes is not qualified parking.

(d) Parking is provided by an employer if—

(1) The parking is on property that the employer owns or leases;

(2) The employer pays for the parking; or

(3) The employer reimburses the employee for parking expenses (see Q/A-16 of this section for rules relating to cash reimbursements).

Q-5. May qualified transportation fringes be provided to individuals who are not employees?

A-5. An employer may provide qualified transportation fringes only to individuals who are currently employees of the employer at the time the qualified transportation fringe is provided. The term employee for purposes of qualified transportation fringes is defined in §1.132-1(b)(2)(i). This term includes only common law employees and other statutory employees, such as officers of corporations. See Q/A-24 of this section for rules regarding partners, 2-percent shareholders, and independent contractors.

Q-6. Must a qualified transportation fringe benefit plan be in writing?

A-6. No. Section 132(f) does not require that a qualified transportation fringe benefit plan be in writing.

Q-7. Is there a limit on the value of qualified transportation fringes that may be excluded from an employee's gross income?

A-7. (a) *Transportation in a commuter highway vehicle and transit passes.* Before January 1, 2002, up to \$65 per

month is excludable from the gross income of an employee for transportation in a commuter highway vehicle and transit passes provided by an employer. On January 1, 2002, this amount is increased to \$100 per month.

(b) *Parking.* Up to \$175 per month is excludable from the gross income of an employee for qualified parking.

(c) *Combination.* An employer may provide qualified parking benefits in addition to transportation in a commuter highway vehicle and transit passes.

(d) *Cost-of-living adjustments.* The amounts in paragraphs (a) and (b) of this Q/A-7 are adjusted annually, beginning with 2000, to reflect cost-of-living. The adjusted figures are announced by the Service before the beginning of the year.

Q-8. What amount is includible in an employee's wages for income and employment tax purposes if the value of the qualified transportation fringe exceeds the applicable statutory monthly limit?

A-8. (a) Generally, an employee must include in gross income the amount by which the fair market value of the benefit exceeds the sum of the amount, if any, paid by the employee and any amount excluded from gross income under section 132(a)(5). Thus, assuming no other statutory exclusion applies, if an employer provides an employee with a qualified transportation fringe that exceeds the applicable statutory monthly limit and the employee does not make any payment, the value of the benefits provided in excess of the applicable statutory monthly limit is included in the employee's wages for income and employment tax purposes. See §1.61-21(b)(1).

(b) The following examples illustrate the principles of this Q/A-8:

Example 1. (i) For each month in a year in which the statutory monthly transit pass limit is \$100 (i.e., a year after 2001), Employer M provides a transit pass valued at \$110 to Employee D, who does not pay any amount to Employer M for the transit pass.

(ii) In this *Example 1*, because the value of the monthly transit pass exceeds the statutory monthly limit by \$10, \$120 (\$110 - \$100, times 12 months) must be included in D's wages for income and employment tax purposes for the year with respect to the transit passes.

Example 2. (i) For each month in a year in which the statutory monthly qualified parking limit is \$175, Employer M provides qualified parking valued at \$195 to Employee E, who does not pay any amount to M for the parking.

(ii) In this *Example 2*, because the fair market value of the qualified parking exceeds the statutory

monthly limit by \$20, \$240 (\$195 - \$175, times 12 months) must be included in Employee E's wages for income and employment tax purposes for the year with respect to the qualified parking.

Example 3. (i) For each month in a year in which the statutory monthly qualified parking limit is \$175, Employer P provides qualified parking with a fair market value of \$220 per month to its employees, but charges each employee \$45 per month.

(ii) In this *Example 3*, because the sum of the amount paid by an employee (\$45) plus the amount excludable for qualified parking (\$175) is not less than the fair market value of the monthly benefit, no amount is includible in the employee's wages for income and employment tax purposes with respect to the qualified parking.

Q-9. Are excludable qualified transportation fringes calculated on a monthly basis?

A-9. (a) *In general.* Yes. The value of transportation in a commuter highway vehicle, transit passes, and qualified parking is calculated on a monthly basis to determine whether the value of the benefit has exceeded the applicable statutory monthly limit on qualified transportation fringes. Except in the case of a transit pass provided to an employee, the applicable statutory monthly limit applies to qualified transportation fringes used by the employee in a month. Monthly exclusion amounts are not combined to provide a qualified transportation fringe for any month exceeding the statutory limit. A month is a calendar month or a substantially equivalent period applied consistently.

(b) *Transit passes.* In the case of transit passes provided to an employee, the applicable statutory monthly limit applies to the transit passes provided by the employer to the employee in a month for that month or for any previous month in the calendar year. In addition, transit passes distributed in advance for more than one month, but not for more than twelve months, are qualified transportation fringes if the requirements in paragraph (c) of this Q/A-9 are met (relating to the income tax and employment tax treatment of advance transit passes). The applicable statutory monthly limit under section 132(f)(2) on the combined amount of transportation in a commuter highway vehicle and transit passes may be calculated by taking into account the monthly limits for all months for which the transit passes are distributed. In the case of a pass that is valid for more than one month, such as an annual pass, the value of the

pass may be divided by the number of months for which it is valid for purposes of determining whether the value of the pass exceeds the statutory monthly limit.

(c) *Rule if employee's employment terminates*— (1) *income tax treatment*. The value of transit passes provided in advance to an employee with respect to a month in which the individual is not an employee is included in the employee's wages for income tax purposes.

(2) *Reporting and employment tax treatment*. Transit passes distributed in advance to an employee are excludable from wages for employment tax purposes under sections 3121, 3306, and 3401 (FICA, FUTA, and income tax withholding) if the employer distributes transit passes to the employee in advance for not more than three months and, at the time the transit passes are distributed, there is not an established date that the employee's employment will terminate (for example, if the employee has given notice of retirement) which will occur before the beginning of the last month of the period for which the transit passes are provided. If the employer distributes transit passes to an employee in advance for not more than three months and at the time the transit passes are distributed there is an established date that the employee's employment will terminate, and the employee's employment does terminate before the beginning of the last month of the period for which the transit passes are provided, the value of transit passes provided for months beginning after the date of termination during which the employee is not employed by the employer is included in the employee's wages for employment tax purposes. If transit passes are distributed in advance for more than three months, the value of transit passes provided for the months during which the employee is not employed by the employer is includible in the employee's wages for employment tax purposes regardless of whether at the time the transit passes were distributed there was an established date of termination of the employee's employment.

(d) *Examples*. The following examples illustrate the principles of this Q/A-9:

Example 1. (i) Employee E incurs \$150 for qualified parking used during the month of June of a year in which the statutory monthly parking limit is \$175, for which E is reimbursed \$150 by Employer R. Employee E incurs \$180 in expenses for qualified parking used during the month of July of that year, for which E is reimbursed \$180 by Employer R.

(ii) In this *Example 1*, because monthly exclusion amounts may not be combined to provide a benefit in any month greater than the applicable statutory limit, the amount by which the amount reimbursed for July exceeds the applicable statutory monthly limit (\$180 minus \$175 equals \$5) is includible in Employee E's wages for income and employment tax purposes.

Example 2. (i) Employee F receives transit passes from Employer G with a value of \$195 in March of a year (for which the statutory monthly transit pass limit is \$65) for January, February, and March of that year. F was hired during January and has not received any transit passes from G.

(ii) In this *Example 2*, the value of the transit passes (three months times \$65 equals \$195) is excludable from F's wages for income and employment tax purposes.

Example 3. (i) Employer S has a qualified transportation fringe benefit plan under which its employees receive transit passes near the beginning of each calendar quarter for that calendar quarter. All employees of Employer S receive transit passes from Employer S with a value of \$195 on March 31 for the second calendar quarter covering the months April, May, and June (of a year in which the statutory monthly transit pass limit is \$65).

(ii) In this *Example 3*, because the value of the transit passes may be calculated by taking into account the monthly limits for all months for which the transit passes are distributed, the value of the transit passes (three months times \$65 equals \$195) is excludable from the employees' wages for income and employment tax purposes.

Example 4. (i) Same facts as in *Example 3*, except that Employee T, an employee of Employer S, terminates employment with S on May 31. There was not an established date of termination for Employee T at the time the transit passes were distributed.

(ii) In this *Example 4*, because at the time the transit passes were distributed there was not an established date of termination for Employee T, the value of the transit passes provided for June (\$65) is excludable from T's wages for employment tax purposes. However, the value of the transit passes distributed to Employee T for June (\$65) is not excludable from T's wages for income tax purposes.

(iii) If Employee T's May 31 termination date was established at the time the transit passes were provided, the value of the transit passes provided for June (\$65) is included in T's wages for both income and employment tax purposes.

Example 5. (i) Employer F has a qualified transportation fringe benefit plan under which its employees receive transit passes semi-annually in advance of the months for which the transit passes are provided. All employees of Employer F, including Employee X, receive transit passes from F with a value of \$390 on June 30 for the 6 months of July through December (of a year in which the statutory monthly transit pass limit is \$65). Employee X's employment terminates and his last day of work is August 1. Employer F's other employees remain employed throughout the remainder of the year.

(ii) In this *Example 5*, the value of the transit passes provided to Employee X for the months September, October, November, and December (\$65 times 4 months equals \$260) of the year is included

in X's wages for income and employment tax purposes. The value of the transit passes provided to Employer F's other employees is excludable from the employees' wages for income and employment tax purposes.

Example 6. (i) Each month during a year in which the statutory monthly transit pass limit is \$65, Employer R distributes transit passes with a face amount of \$70 to each of its employees. Transit passes with a face amount of \$70 can be purchased from the transit system by any individual for \$65.

(ii) In this *Example 6*, because the value of the transit passes distributed by Employer R does not exceed the applicable statutory monthly limit (\$65), no portion of the value of the transit passes is included as wages for income and employment tax purposes.

Q-10. May an employee receive qualified transportation fringes from more than one employer?

A-10. (a) *General rule*. Yes. The statutory monthly limits described in Q/A-7 of this section apply to benefits provided by an employer to its employees. For this purpose, all employees treated as employed by a single employer under section 414(b), (c), (m), or (o) are treated as employed by a single employer. See section 414(t) and §1.132-1(c). Thus, qualified transportation fringes paid by entities under common control under section 414(b), (c), (m), or (o) are combined for purposes of applying the applicable statutory monthly limit. In addition, an individual who is treated as a leased employee of the employer under section 414(n) is treated as an employee of that employer for purposes of section 132. See section 414(n)(3)(C).

(b) *Examples*. The following examples illustrate the principles of this Q/A-10:

Example 1. (i) During a year in which the statutory monthly qualified parking limit is \$175, Employee E works for Employers M and N, who are unrelated and not treated as a single employer under section 414(b), (c), (m), or (o). Each month, M and N each provide qualified parking benefits to E with a value of \$100.

(ii) In this *Example 1*, because M and N are unrelated employers, and the value of the monthly parking benefit provided by each is not more than the applicable statutory monthly limit, the parking benefits provided by each employer are excludable as qualified transportation fringes assuming that the other requirements of this section are satisfied.

Example 2. (i) Same facts as in *Example 1*, except that Employers M and N are treated as a single employer under section 414(b).

(ii) In this *Example 2*, because M and N are treated as a single employer, the value of the monthly parking benefit provided by M and N must be combined for purposes of determining whether the applicable statutory monthly limit has been exceeded. Thus, the amount by which the value of the park-

ing benefit exceeds the monthly limit (\$200 minus the monthly limit amount of \$175 equals \$25) for each month in the year is includible in E's wages for income and employment tax purposes.

Q-11. May qualified transportation fringes be provided to employees pursuant to a compensation reduction agreement?

A-11. Yes. An employer may offer employees a choice between cash compensation and any qualified transportation fringe. An employee who is offered this choice and who elects qualified transportation fringes is not required to include the cash compensation in income if—

(a) The election is pursuant to an arrangement described in Q/A-12 of this section;

(b) The amount of the reduction in cash compensation does not exceed the limitation in Q/A-13 of this section;

(c) The arrangement satisfies the timing and reimbursement rules in Q/A-14 and 16 of this section; and

(d) The related fringe benefit arrangement otherwise satisfies the requirements set forth elsewhere in this section.

Q-12. What is a compensation reduction election for purposes of section 132(f)?

A-12. (a) *Election requirements generally.* A compensation reduction arrangement is an arrangement under which the employer provides the employee with the right to elect whether the employee will receive either a fixed amount of cash compensation at a specified future date or a fixed amount of qualified transportation fringes to be provided for a specified future period (such as qualified parking to be used during a future calendar month). The employee's election must be in writing or another form, such as electronic, that includes, in a permanent and verifiable form, the information required to be in the election. The election must contain the date of the election, the amount of the compensation to be reduced, and the period for which the benefit will be provided. The election must relate to a fixed dollar amount or fixed percentage of compensation reduction. An election to reduce compensation for a period by a set amount for such period may be automatically renewed for subsequent periods.

(b) *Automatic election permitted.* An employer may provide under its qualified transportation fringe benefit plan that a compensation reduction election will be

deemed to have been made if the employee does not elect to receive cash compensation in lieu of the qualified transportation fringe, provided that the employee receives adequate notice that a compensation reduction will be made and is given adequate opportunity to choose to receive the cash compensation instead of the qualified transportation fringe.

Q-13. Is there a limit to the amount of the compensation reduction?

A-13. Yes. Each month, the amount of the compensation reduction may not exceed the combined applicable statutory monthly limits for transportation in a commuter highway vehicle, transit passes, and qualified parking. For example, for a year in which the statutory monthly limit is \$65 for transportation in a commuter highway vehicle and transit passes, and \$175 for qualified parking, an employee could elect to reduce compensation for any month by no more than \$240 (\$65 plus \$175) with respect to qualified transportation fringes. If an employee were to elect to reduce compensation by \$250 for a month, the excess \$10 (\$250 minus \$240) would be includible in the employee's wages for income and employment tax purposes.

Q-14. When must the employee have made a compensation reduction election and under what circumstances may the amount be paid in cash to the employee?

A-14. (a) The compensation reduction election must satisfy the requirements set forth under paragraphs (b), (c), and (d) of this Q/A-14.

(b) *Timing of election.* The compensation reduction election must be made before the employee is able currently to receive the cash or other taxable amount at the employee's discretion. The determination of whether the employee is able currently to receive the cash does not depend on whether it has been constructively received for purposes of section 451. The election must specify that the period (such as a calendar month) for which the qualified transportation fringe will be provided must not begin before the election is made. Thus, a compensation reduction election must relate to qualified transportation fringes to be provided after the election. For this purpose, the date a qualified transportation fringe is provided is—

(1) The date the employee receives a voucher or similar item; or

(2) In any other case, the date the employee uses the qualified transportation fringe.

(c) *Revocability of elections.* The employee may not revoke a compensation reduction election after the employee is able currently to receive the cash or other taxable amount at the employee's discretion. In addition, the election may not be revoked after the beginning of the period for which the qualified transportation fringe will be provided.

(d) *Compensation reduction amounts not refundable.* Unless an election is revoked in a manner consistent with paragraph (c) of this Q/A-14, an employee may not subsequently receive the compensation (in cash or any form other than by payment of a qualified transportation fringe under the employer's plan). Thus, an employer's qualified transportation fringe benefit plan may not provide that an employee who ceases to participate in the employer's qualified transportation fringe benefit plan (such as in the case of termination of employment) is entitled to receive a refund of the amount by which the employee's compensation reductions exceed the actual qualified transportation fringes provided to the employee by the employer.

(e) *Examples.* The following examples illustrate the principles of this Q/A-14:

Example 1. (i) Employer P maintains a qualified transportation fringe benefit arrangement during a year in which the statutory monthly limit is \$100 for transportation in a commuter highway vehicle and transit passes (2002 or later) and \$180 for qualified parking. Employees of P are paid cash compensation twice per month, with the payroll dates being the first and the fifteenth day of the month. Under P's arrangement, an employee is permitted to elect at any time before the first day of a month to reduce his or her compensation payable during that month in an amount up to the applicable statutory monthly limit (\$100 if the employee elects coverage for transportation in a commuter highway vehicle or a mass transit pass, or \$180 if the employee chooses qualified parking) in return for the right to receive qualified transportation fringes up to the amount of the election. If such an election is made, P will provide a mass transit pass for that month with a value not exceeding the compensation reduction amount elected by the employee or will reimburse the cost of other qualified transportation fringes used by the employee on or after the first day of that month up to the compensation reduction amount elected by the employee. Any compensation reduction amount elected by the employee for the month that is not used for qualified transportation fringes is not refunded to the employee at any future date.

(ii) In this *Example 1*, the arrangement satisfies the requirements of this Q/A-14 because the election

is made before the employee is able currently to receive the cash and the election specifies the future period for which the qualified transportation fringes will be provided. The arrangement would also satisfy the requirements of this Q/A-14 and Q/A-13 of this section if employees are allowed to elect to reduce compensation up to \$280 per month (\$100 plus \$180).

(iii) The arrangement would also satisfy the requirements of this Q/A-14 (and Q/A-13 of this section) if employees are allowed to make an election at any time before the first or the fifteenth day of the month to reduce their compensation payable on that payroll date by an amount not in excess of one-half of the applicable statutory monthly limit (depending on the type of qualified transportation fringe elected by the employee) and P provides a mass transit pass on or after the applicable payroll date for the compensation reduction amount elected by the employee for the payroll date or reimburses the cost of other qualified transportation fringes used by the employee on or after the payroll date up to the compensation reduction amount elected by the employee for that payroll date.

Example 2. (i) Employee Q elects to reduce his compensation payable on March 1 of a year (for which the statutory monthly mass transit limit is \$65) by \$195 in exchange for a mass transit voucher to be provided in March. The election is made on the preceding February 27. Employee Q was hired in January of the year. On March 10 of the year, the employer of Employee Q delivers to Employee Q a mass transit voucher worth \$195 for the months of January, February, and March.

(ii) In this *Example 2*, \$65 is included in Employee Q's wages for income and employment tax purposes because the compensation reduction election fails to satisfy the requirement in this Q/A-14 and Q/A-12 of this section that the period for which the qualified transportation fringe will be provided not begin before the election is made to the extent the election relates to \$65 worth of transit passes for January of the year. The \$65 for February is not taxable because the election was for a future period that includes at least one day in February.

(iii) However, no amount would be included in Employee Q's wages as a result of the election if \$195 worth of mass transit passes were instead provided to Q for the months of February, March, and April (because the compensation reduction would relate solely to fringes to be provided for a period not beginning before the date of the election and the amount provided does not exceed the aggregate limit for the period, i.e., the sum of \$65 for each of February, March, and April). See Q/A-9 of this section for rules governing transit passes distributed in advance for more than one month.

Example 3. (i) Employee R elects to reduce his compensation payable on March 1 of a year (for which the statutory monthly parking limit is \$175) by \$185 in exchange for reimbursement by Employer T of parking expenses incurred by Employee R for parking on or near Employer T's business premises during the period beginning after the date of the election through March. The election is made on the preceding February 27. Employee R incurs \$10 in parking expenses on February 28 of the year, and \$175 in parking expenses during the month

of March. On April 5 of the year, Employer T reimburses Employee R \$185 for the parking expenses incurred on February 28, and during March, of the year.

(ii) In this *Example 3*, no amount would be includible in Employee R's wages for income and employment tax purposes because the compensation reduction related solely to parking on or near Employer R's business premises used during a period not beginning before the date of the election and the amount reimbursed for parking used in any one month does not exceed the statutory monthly limitation.

Q-15. May an employee whose qualified transportation fringe costs are less than the employee's compensation reduction carry over this excess amount to subsequent periods?

A-15. (a) Yes. An employee may carry over unused compensation reduction amounts to subsequent periods under the plan of the employee's employer.

(b) The following example illustrates the principles of this Q/A-15:

Example. (i) By an election made before November 1 of a year for which the statutory monthly mass transit limit is \$65, Employee E elects to reduce compensation in the amount of \$65 for the month of November. E incurs \$50 in employee-operated commuter highway vehicle expenses during November for which E is reimbursed \$50 by Employer R, E's employer. By an election made before December, E elects to reduce compensation by \$65 for the month of December. E incurs \$65 in employee-operated commuter highway vehicle expenses during December for which E is reimbursed \$65 by R. Before the following January, E elects to reduce compensation by \$50 for the month of January. E incurs \$65 in employee-operated commuter highway vehicle expenses during January for which E is reimbursed \$65 by R because R allows E to carry over to the next year the \$15 amount by which the compensation reductions for November and December exceeded the employee-operated commuter highway vehicle expenses incurred during those months.

(ii) In this *Example*, because Employee E is reimbursed in an amount not exceeding the applicable statutory monthly limit, and the reimbursement does not exceed the amount of employee-operated commuter highway vehicle expenses incurred during the month of January, the amount reimbursed (\$65) is excludable from E's wages for income and employment tax purposes.

Q-16. How does section 132(f) apply to expense reimbursements?

A-16. (a) *In general.* The term qualified transportation fringe includes cash reimbursement by an employer to an employee for expenses incurred or paid by an employee for transportation in a commuter highway vehicle or qualified parking. The term qualified transportation fringe also includes cash reimburse-

ment for transit passes made under a *bona fide* reimbursement arrangement, but, in accordance with section 132(f)(3), only if permitted under paragraph (b) of this Q/A-16. The reimbursement must be made under a *bona fide* reimbursement arrangement which meets the rules of paragraph (c) of this Q/A-16. A payment made before the date an expense has been incurred or paid is not a reimbursement. In addition, a *bona fide* reimbursement arrangement does not include an arrangement that is dependent solely upon an employee certifying in advance that the employee will incur expenses at some future date.

(b) *Special rule for transit passes—*(1) *In general.* The term *qualified transportation fringe* includes cash reimbursement for transit passes made under a *bona fide* reimbursement arrangement, but, in accordance with section 132(f)(3), only if no voucher or similar item that may be exchanged only for a transit pass is readily available for direct distribution by the employer to employees. If a voucher is readily available, the requirement that a voucher be distributed in-kind by the employer is satisfied if the voucher is distributed by the employer or by another person on behalf of the employer (for example, if a transit operator credits amounts to the employee's fare card as a result of payments made to the operator by the employer).

(2) *Voucher or similar item.* For purposes of the special rule in paragraph (b) of this Q/A-16, a transit system voucher is an instrument that may be purchased by employers from a voucher provider that is accepted by one or more mass transit operators (e.g., train, subway, and bus) in an area as fare media or in exchange for fare media. Thus, for example, a transit pass that may be purchased by employers directly from a voucher provider is a transit system voucher.

(3) *Voucher provider.* The term voucher provider means any person in the trade or business of selling transit system vouchers to employers, or any transit system or transit operator that sells vouchers to employers for the purpose of direct distribution to employees. Thus, a transit operator might or might not be a voucher provider. A voucher provider is not, for example, a third-party employee benefits

administrator that administers a transit pass benefit program for an employer using vouchers that the employer could obtain directly.

(4) *Readily available.* For purposes of this paragraph (b), a voucher or similar item is readily available for direct distribution by the employer to employees if and only if an employer can obtain it from a voucher provider that—

(i) does not impose fare media charges that cause vouchers to not be readily available as described in paragraph (b)(5) of this section; and

(ii) does not impose other restrictions that cause vouchers to not be readily available as described in paragraph (b)(6) of this section.

(5) *Fare media charges.* For purposes of paragraph (b)(4) of this section, fare media charges relate only to fees paid by the employer to voucher providers for vouchers. The determination of whether obtaining a voucher would result in fare media charges that cause vouchers to not be readily available as described in this paragraph (b) is made with respect to each transit system voucher. If more than one transit system voucher is available for direct distribution to employees, the employer must consider the fees imposed for the lowest cost monthly voucher for purposes of determining whether the fees imposed by the voucher provider satisfy this paragraph. However, if transit system vouchers for multiple transit systems are required in an area to meet the transit needs of the individual employees in that area, the employer has the option of averaging the costs applied to each transit system voucher for purposes of determining whether the fare media charges for transit system vouchers satisfy this paragraph. Fare media charges are described in this paragraph (b)(5), and therefore cause vouchers to not be readily available, if and only if the average annual fare media charges that the employer reasonably expects to incur for transit system vouchers purchased from the voucher provider (disregarding reasonable and customary delivery charges imposed by the voucher provider, e.g., not in excess of \$15) are more than 1 percent of the average annual value of the vouchers for a transit system.

(6) *Other restrictions.* For purposes of paragraph (b)(4) of this section, restrictions that cause vouchers to not be readily

available are restrictions imposed by the voucher provider other than fare media charges that effectively prevent the employer from obtaining vouchers appropriate for distribution to employees. Examples of such restrictions include—

(i) *Advance purchase requirements.* Advance purchase requirements cause vouchers to not be readily available only if the voucher provider does not offer vouchers at regular intervals or fails to provide the voucher within a reasonable period after receiving payment for the voucher. For example, a requirement that vouchers may be purchased only once per year may effectively prevent an employer from obtaining vouchers for distribution to employees. An advance purchase requirement that vouchers be purchased not more frequently than monthly does not effectively prevent the employer from obtaining vouchers for distribution to employees.

(ii) *Purchase quantity requirements.* Purchase quantity requirements cause vouchers to not be readily available if the voucher provider does not offer vouchers in quantities that are reasonably appropriate to the number of the employer's employees who use mass transportation (for example, the voucher provider requires a \$1,000 minimum purchase and the employer seeks to purchase only \$200 of vouchers).

(iii) *Limitations on denominations of vouchers that are available.* If the voucher provider does not offer vouchers in denominations appropriate for distribution to the employer's employees, vouchers are not readily available. For example, vouchers provided in \$5 increments up to the monthly limit are appropriate for distribution to employees, while vouchers available only in a denomination equal to the monthly limit are not appropriate for distribution to employees if the amount of the benefit provided to the employer's employees each month is normally less than the monthly limit.

(7) *Example.* The following example illustrates the principles of this paragraph (b):

Example. (i) Company C in City X sells mass transit vouchers to employers in the metropolitan area of X in various denominations appropriate for distribution to employees. Employers can purchase vouchers monthly in reasonably appropriate quantities. Several different bus, rail, van pool, and ferry operators service X, and a number of the operators accept

the vouchers either as fare media or in exchange for fare media. To cover its operating expenses, C imposes on each voucher a 50 cents charge, plus a reasonable and customary \$15 charge for delivery of each order of vouchers. Employer M disburses vouchers purchased from C to its employees who use operators that accept the vouchers and M reasonably expects that \$55 is the average value of the voucher it will purchase from C for the next calendar year.

(ii) In this *Example*, vouchers for X are readily available for direct distribution by the employer to employees because the expected cost of the vouchers disbursed to M's employees for the next calendar year is not more than 1 percent of the value of the vouchers (50 cents divided by \$55 equals 0.91 percent), the delivery charges are disregarded because they are reasonable and customary, and there are no other restrictions that cause the vouchers to not be readily available. Thus, any reimbursement of mass transportation costs in X would not be a qualified transportation fringe.

(c) *Substantiation requirements.* Employers that make cash reimbursements must establish a *bona fide* reimbursement arrangement to establish that their employees have, in fact, incurred expenses for transportation in a commuter highway vehicle, transit passes, or qualified parking. For purposes of section 132(f), whether cash reimbursements are made under a *bona fide* reimbursement arrangement may vary depending on the facts and circumstances, including the method or methods of payment utilized within the mass transit system. The employer must implement reasonable procedures to ensure that an amount equal to the reimbursement was incurred for transportation in a commuter highway vehicle, transit passes, or qualified parking. The expense must be substantiated within a reasonable period of time. An expense substantiated to the payor within 180 days after it has been paid will be treated as having been substantiated within a reasonable period of time. An employee certification at the time of reimbursement in either written or electronic form may be a reasonable reimbursement procedure depending on the facts and circumstances. Examples of reasonable reimbursement procedures are set forth in paragraph (d) of this Q/A-16.

(d) *Illustrations of reasonable reimbursement procedures.* The following are examples of reasonable reimbursement procedures for purposes of paragraph (c) of this Q/A-16. In each case, the reimbursement is made at or within a reasonable period after the end of the events described in paragraphs (d)(1) through (d)(3) of this section.

(1) An employee presents to the employer a parking expense receipt for parking on or near the employer's business premises, the employee certifies that the parking was used by the employee, and the employer has no reason to doubt the employee's certification.

(2) An employee either submits a used time-sensitive transit pass (such as a monthly pass) to the employer and certifies that he or she purchased it or presents an unused or used transit pass to the employer and certifies that he or she purchased it and the employee certifies that he or she has not previously been reimbursed for the transit pass. In both cases, the employer has no reason to doubt the employee's certification.

(3) If a receipt is not provided in the ordinary course of business (e.g., if the employee uses metered parking or if used transit passes cannot be returned to the user), the employee certifies to the employer the type and the amount of expenses incurred, and the employer has no reason to doubt the employee's certification.

Q-17. May an employer provide non-taxable cash reimbursement under section 132(f) for periods longer than one month?

A-17. (a) *General rule.* Yes. Qualified transportation fringes include reimbursement to employees for costs incurred for transportation in more than one month, provided the reimbursement for each month in the period is calculated separately and does not exceed the applicable statutory monthly limit for any month in the period. See Q/A-8 and 9 of this section if the limit for a month is exceeded.

(b) *Example.* The following example illustrates the principles of this Q/A-17:

Example. (i) Employee R pays \$100 per month for qualified parking used during the period from April 1 through June 30 of a year in which the statutory monthly qualified parking limit is \$175. After receiving adequate substantiation from Employee R, R's employer reimburses R \$300 in cash on June 30 of that year.

(ii) In this *Example*, because the value of the reimbursed expenses for each month did not exceed the applicable statutory monthly limit, the \$300 reimbursement is excludable from R's wages for income and employment tax purposes as a qualified transportation fringe.

Q-18. What are the substantiation requirements if an employer distributes transit passes?

A-18. There are no substantiation requirements if the employer distributes

transit passes. Thus, an employer may distribute a transit pass for each month with a value not more than the statutory monthly limit without requiring any certification from the employee regarding the use of the transit pass.

Q-19. May an employer choose to impose substantiation requirements in addition to those described in this regulation?

A-19. Yes.

Q-20. How is the value of parking determined?

A-20. Section 1.61-21(b)(2) applies for purposes of determining the value of parking.

Q-21. How do the qualified transportation fringe rules apply to van pools?

A-21. (a) *Van pools generally.* Employer and employee-operated van pools, as well as private or public transit-operated van pools, may qualify as qualified transportation fringes. The value of van pool benefits which are qualified transportation fringes may be excluded up to the applicable statutory monthly limit for transportation in a commuter highway vehicle and transit passes, less the value of any transit passes provided by the employer for the month.

(b) *Employer-operated van pools.* The value of van pool transportation provided by or for an employer to its employees is excludable as a qualified transportation fringe, provided the van qualifies as a commuter highway vehicle as defined in section 132(f)(5)(B) and Q/A-2 of this section. A van pool is operated by or for the employer if the employer purchases or leases vans to enable employees to commute together or the employer contracts with and pays a third party to provide the vans and some or all of the costs of operating the vans, including maintenance, liability insurance and other operating expenses.

(c) *Employee-operated van pools.* Cash reimbursement by an employer to employees for expenses incurred for transportation in a van pool operated by employees independent of their employer are excludable as qualified transportation fringes, provided that the van qualifies as a commuter highway vehicle as defined in section 132(f)(5)(B) and Q/A-2 of this section. See Q/A-16 of this section for the rules governing cash reimbursements.

(d) *Private or public transit-operated van pool transit passes.* The qualified

transportation fringe exclusion for transit passes is available for travel in van pools owned and operated either by public transit authorities or by any person in the business of transporting persons for compensation or hire. In accordance with paragraph (b) of Q/A-3 of this section, the van must seat at least 6 adults (excluding the driver). See Q/A-16(b) and (c) of this section for a special rule for cash reimbursement for transit passes and the substantiation requirements for cash reimbursement.

(e) *Value of van pool transportation benefits.* Section 1.61-21(b)(2) provides that the fair market value of a fringe benefit is based on all the facts and circumstances. Alternatively, transportation in an employer-provided commuter highway vehicle may be valued under the automobile lease valuation rule in §1.61-21(d), the vehicle cents-per-mile rule in §1.61-21(e), or the commuting valuation rule in §1.61-21(f). If one of these special valuation rules is used, the employer must use the same valuation rule to value the use of the commuter highway vehicle by each employee who share the use. See §1.61-21(c)(2)(i)(B).

(f) *Qualified parking prime member.* If an employee obtains a qualified parking space as a result of membership in a car or van pool, the applicable statutory monthly limit for qualified parking applies to the individual to whom the parking space is assigned. This individual is the prime member. In determining the tax consequences to the prime member, the statutory monthly limit amounts of each car pool member may not be combined. If the employer provides access to the space and the space is not assigned to a particular individual, then the employer must designate one of its employees as the prime member who will bear the tax consequences. The employer may not designate more than one prime member for a car or van pool during a month. The employer of the prime member is responsible for including the value of the qualified parking in excess of the statutory monthly limit in the prime member's wages for income and employment tax purposes.

Q-22. What are the reporting and employment tax requirements for qualified transportation fringes?

A-22. (a) *Employment tax treatment generally.* Qualified transportation

fringes not exceeding the applicable statutory monthly limit described in Q/A-7 of this section are not wages for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding. Any amount by which an employee elects to reduce compensation as provided in Q/A-11 of this section is not subject to the FICA, the FUTA, and federal income tax withholding. Qualified transportation fringes exceeding the applicable statutory monthly limit described in Q/A-7 of this section are wages for purposes of the FICA, the FUTA, and federal income tax withholding and are reported on the employee's Form W-2, Wage and Tax Statement.

(b) *Employment tax treatment of cash reimbursement exceeding monthly limits.* Cash reimbursement to employees (for example, cash reimbursement for qualified parking) in excess of the applicable statutory monthly limit under section 132(f) is treated as paid for employment tax purposes when actually or constructively paid. See §§31.3121(a)-2(a), 31.3301-4, 31.3402(a)-1(b) of this chapter. Employers must report and deposit the amounts withheld in addition to reporting and depositing other employment taxes. See Q/A-16 of this section for rules governing cash reimbursements.

(c) *Noncash fringe benefits exceeding monthly limits.* If the value of noncash qualified transportation fringes exceeds the applicable statutory monthly limit, the employer may elect, for purposes of the FICA, the FUTA, and federal income tax withholding, to treat the noncash taxable fringe benefits as paid on a pay period, quarterly, semi-annual, annual, or other basis, provided that the benefits are treated as paid no less frequently than annually.

Q-23. How does section 132(f) interact with other fringe benefit rules?

A-23. For purposes of section 132, the terms working condition fringe and *de minimis* fringe do not include any qualified transportation fringe under section 132(f). If, however, an employer provides local transportation other than transit passes (without any direct or indirect

compensation reduction election), the value of the benefit may be excludable, either totally or partially, under fringe benefit rules other than the qualified transportation fringe rules under section 132(f). See §§1.132-6(d)(2)(i) (occasional local transportation fare), 1.132-6(d)(2)(iii) (transportation provided under unusual circumstances), and 1.61-21(k) (valuation of local transportation provided to qualified employees). See also Q/A-4(b) of this section.

Q-24. May qualified transportation fringes be provided to individuals who are partners, 2-percent shareholders of S-corporations, or independent contractors?

A-24. (a) *General rule.* Section 132(f)(5)(E) states that self-employed individuals who are employees within the meaning of section 401(c)(1) are not employees for purposes of section 132(f). Therefore, individuals who are partners, sole proprietors, or other independent contractors are not employees for purposes of section 132(f). In addition, under section 1372(a), 2-percent shareholders of S corporations are treated as partners for fringe benefit purposes. Thus, an individual who is both a 2-percent shareholder of an S corporation and a common law employee of that S corporation is not considered an employee for purposes of section 132(f). However, while section 132(f) does not apply to individuals who are partners, 2-percent shareholders of S corporations, or independent contractors, other exclusions for working condition and *de minimis* fringes may be available as described in paragraphs (b) and (c) of this Q/A-24. See §§1.132-1(b)(2) and 1.132-1(b)(4).

(b) *Transit passes.* The working condition and *de minimis* fringe exclusions under section 132(a)(3) and (4) are available for transit passes provided to individuals who are partners, 2-percent shareholders, and independent contractors. For example, tokens or farecards provided by a partnership to an individual who is a partner that enable the partner to commute on a public transit system (not including privately-operated van pools) are excludable from the partner's gross income if the value of the tokens and farecards in any

month does not exceed the dollar amount specified in §1.132-6(d)(1). However, if the value of a pass provided in a month exceeds the dollar amount specified in §1.132-6(d)(1), the full value of the benefit provided (not merely the amount in excess of the dollar amount specified in §1.132-6(d)(1)) is includible in gross income.

(c) *Parking.* The working condition fringe rules under section 132(d) do not apply to commuter parking. See §1.132-5(a)(1). However, the *de minimis* fringe rules under section 132(e) are available for parking provided to individuals who are partners, 2-percent shareholders, or independent contractors that qualifies under the *de minimis* rules. See §1.132-6(a) and (b).

(d) *Example.* The following example illustrates the principles of this Q/A-24:

Example. (i) Individual G is a partner in partnership P. Individual G commutes to and from G's office every day and parks free of charge in P's lot.

(ii) In this *Example*, the value of the parking is not excluded under section 132(f), but may be excluded under section 132(e) if the parking is a *de minimis* fringe under §1.132-6.

Q-25. What is the effective date of this section?

A-25. (a) Except as provided in paragraph (b) of this Q/A-25, this section is applicable for taxable years beginning after December 31, 2001.

(b) The last sentence of paragraph (b)(5) of Q/A-16 of this section (relating to whether transit system vouchers for transit passes are readily available) is effective for taxable years beginning after December 31, 2003.

PART 602 — OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 5. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

* * * * *

1.132–9(b) 1545–1676

* * * * *

Robert E. Wenzel,
*Deputy Commissioner
of Internal Revenue.*

Approved December 29, 2000.

Jonathan Talisman,
*Acting Assistant Secretary
of the Treasury.*

(Filed by the Office of the Federal Register on January 10, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 11, 2001, 66 F.R. 2241)

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of March 2001. See Rev. Rul. 2001–12, page 811.

Section 367.— Foreign Corporations

26 CFR 1.367(b)–12: *Subsequent treatment of amounts attributed or included in income.*

T.D. 8937

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 7

Stock Transfer Rules: Transition Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations addressing distributions with respect to, or a disposition of, certain stock that was subject to prior temporary regulations under section 367(b). Section 367(b) addresses the application of non-recognition exchange provisions in Subchapter C of the Internal Revenue Code to transactions that involve one or more foreign corporations.

DATES: *Effective Date.* These regulations are effective as of January 11, 2001.

Applicability Dates. These regulations apply to distributions or dispositions that occur on or after January 11, 2001.

FOR FURTHER INFORMATION CONTACT: Mark D. Harris, (202) 622-3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On January 24, 2000, the IRS and Treasury issued final regulations under section 367(b) of the Internal Revenue Code (Code). At the same time, the IRS and Treasury also modified temporary regulation §7.367(b)–12(a). The final regulations and modified temporary regulation were effective as of February 23, 2000.

As modified, §7.367(b)–12(a) addresses distributions with respect to, or a disposition of, stock that was subject to certain provisions of the temporary section 367(b) regulations that were in effect before February 23, 2000. This document finalizes the rule stated in §7.367(b)–12(a) in order to insure its continued application. See section 7805(e)(2) (stating a “sunset rule” applicable to temporary regulations).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small

Business Administration for comment on the impact of the proposed regulations on small business.

Drafting Information

The principal author of these regulations is Mark Harris of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 7 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.367(b)–12 also issued under 26 U.S.C. 367(a) and (b). * * *

Par. 2. Section 1.367(b)–0 is amended by revising the introductory text and adding entries for §1.367(b)–12 to read as follows:

§1.367(b)–0 Table of contents.

This section lists the paragraphs contained in §§1.367(b)–1 through 1.367(b)–6 and 1.367(b)–12.

* * * * *

§1.367(b)–12 Subsequent treatment of amounts attributed or included in income.

- (a) In general.
- (b) Applicable rules.
- (c) Effective date.

Par. 3. Section 1.367(b)–12 is added to read as follows:

§1.367(b)–12 Subsequent treatment of amounts attributed or included in income.

(a) *In general.* This section applies to distributions with respect to, or a disposition of, stock—

(1) To which, in connection with an exchange occurring before February 23, 2000, an amount has been attributed pursuant to §7.367(b)–9 or 7.367(b)–10 of this chapter (as in effect prior to February 23, 2000, see 26 CFR part 1 revised as of April 1, 1999); or

(2) In respect of which, before February 23, 2000, an amount has been included in income or added to earnings and profits pursuant to §7.367(b)–7 or 7.367(b)–10 of this chapter (as in effect prior to February 23, 2000, see 26 CFR part 1 revised as of April 1, 1999).

(b) *Applicable rules.* See §7.367(b)–12(b) through (e) of this chapter (as in effect prior to January 11, 2001, see 26 CFR part 1 revised as of April 1, 2000) for purposes of applying paragraph (a) of this section.

(c) *Effective date.* This section applies to distributions or dispositions that occur on or after January 11, 2001.

PART 7—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1976

Par. 4. The authority citation for part 7 is amended by removing the entry for §7.367(b)–12 and continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§7.367(b)–12 [Removed]

Par. 5. Section 7.367(b)–12 is removed.

Robert E. Wenzel,
*Deputy Commissioner of
Internal Revenue.*

Approved December 28, 2000.

Jonathan Talisman,
*Acting Assistant Secretary
of the Treasury.*

(Filed by the Office of the Federal Register on January 10, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 11, 2001, 66 F.R. 2256)

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of March 2001. See Rev. Rul. 2001–12, page 811.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2001. See Rev. Rul. 2001–12, page 811.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2001. See Rev. Rul. 2001–12, page 811.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of March 2001. See Rev. Rul. 2001–12, page 811.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2001. See Rev. Rul. 2001–12, page 811.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of March 2001. See Rev. Rul. 2001–12, page 811.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2001. See Rev. Rul. 2001–12, page 811.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2001. See Rev. Rul. 2001–12, page 811.

Section 985.—Functional Currency

26 CFR 1.985–8: *Special rules applicable to the European Monetary Union (conversion to euro).*

T.D. 8927

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Conversion to the Euro

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final Income Tax Regulations relating to U.S. taxpayers operating, investing, or otherwise conducting business in the currencies of certain European countries that replace their national currencies with a single, multinational currency called the euro. These regulations provide rules relating to adjustments required for qualified business units operating in such currencies and rules relating to the tax effect of holding such currencies, or financial instruments or contracts denominated in such currencies.

DATES: *Effective Date:* These regulations are effective January 11, 2001.

Applicability Date: These regulations are applicable for tax years ending after July 29, 1998.

FOR FURTHER INFORMATION CONTACT: John W. Rogers III of the Office of Associate Chief Counsel (International), (202) 622-3870, regarding the change in functional currency rules and Thomas Preston of the Office of Assistant Chief Counsel (Financial Institutions and Products), (202) 622-3930, regarding section 1001 (not toll free calls).

SUPPLEMENTARY INFORMATION:

Background

On March 9, 1998, the IRS issued Announcement 98–18 (1998–1 C.B. 676) requesting comments relating to the tax issues for U.S. taxpayers operating, investing, or otherwise conducting business in a currency that is converting to the euro. Numerous comments were received.

After consideration of the comments, and in order to provide immediate guidance, the Treasury and the IRS published in the **Federal Register** temporary regulations (63 FR 40366) and a notice of proposed rulemaking by cross-reference to the temporary regulations (63 F.R. 40383 [T.D. 8776, 1998-2 C.B. 200]) on July 29, 1998. No public hearing was held in conjunction with the notice of proposed rulemaking because no taxpayers requested to speak at the hearing.

In the notice of proposed rulemaking, the Treasury and The IRS requested comments with respect to certain additional issues. Two comments were received in connection with the request for comments and are discussed in greater detail below.

Explanation of Provisions and Discussion of Comments

The temporary regulations provide rules relating to U.S. taxpayers operating, investing, or otherwise conducting business in the currencies of countries that replace their national currencies (legacy currencies) with a single, multinational currency called the euro. Thus, a legacy currency would include former currencies of the eleven countries that adopted the euro in 1999 as well as the currency of a country after it adopts the euro at some later date. The temporary regulations generally provide guidance relating to the circumstances under which the euro conversion creates a realization event with respect to instruments and contracts denominated in a legacy currency, and the circumstances under which the euro conversion constitutes a change in functional currency for a qualified business unit (QBU or QBUs, as the case may be) whose functional currency is a legacy currency, and certain consequences thereof. The temporary regulations published in the **Federal Register** on July 29, 1998, are finalized substantially as proposed. See the preamble to the temporary regulations for an explanation of the provisions of those regulations.

As noted above, two comments were received in connection with the publication of the temporary regulations and the notice of proposed rulemaking. One comment addressed the effect of the euro conversion to a corporation that has significant numbers of legacy currency transactions but has a non-legacy curren-

cy as its functional currency. For example, a corporation may have a non-legacy currency as its functional currency because its economic environment reflected more significant activities denominated in such currency (e.g., the U.S. dollar or the Swiss franc) relative to any single legacy currency. However, given the aggregation of the individual legacy currencies into the euro, the currency of the corporation's economic environment in which a significant part of its activities are conducted is the euro. The commenter suggested that, in such circumstances, the corporation should be allowed to change its functional currency to the euro automatically.

In response to the comment, the regulation provides a new rule in which a QBU that uses a non-legacy currency as its functional currency may change its functional currency to the euro provided that the euro is a currency of the economic environment in which a significant part of the QBU's activities are conducted, the QBU maintains its books and records in the euro after conversion, and the QBU is not required to use the dollar as its functional currency. The change is deemed to be made with the consent of the Commissioner if the change is made within the period set forth in §1.985-8(b)(2). A QBU changing its functional currency under this new rule is required to make the change in method of accounting adjustments under §1.985-5. Treasury and the IRS believe that the rules of §1.985-5 appropriately apply to this circumstance because the change in functional currency is not an involuntary change of the same nature as a QBU whose functional currency is a legacy currency.

The second comment suggested that the temporary regulations do not provide clear guidance in the case where, prior to conversion, the functional currency of a taxpayer and one of its QBU branches is the same legacy currency, and either the taxpayer or its QBU branch converts to the euro as its functional currency in a taxable year prior to the conversion of the other. The comment noted that the temporary regulations presume that the taxpayer and its branch have a different functional currency, but do not address instances where they have the same functional currency. The comment recom-

mended that the regulations provide rules that require calculation of section 987 gain or loss during the period in which the taxpayer and its branch have different functional currencies. The recommendation is not adopted because section 987 currency gain or loss should not arise when a taxpayer and its branch use the same legacy currency as their functional currencies even if each adopts the euro as its functional currency in different years.

Finally, the notice of proposed rulemaking requested comments regarding the treatment of section 988 transactions that are held by euro functional currency QBUs and that are denominated in a currency that is replaced by the euro in the future. While no comments were received, Treasury and the IRS believe that rules relating to this issue should be clarified. Accordingly, §1.985-8(d) provides that the principles of §1.985-8(c)(3) apply in this context. Under this rule, legacy currency transactions generally continue to be treated as section 988 transactions and the principles of section 988 apply. Further, the principles provided in §1.985-8(c)(3)(iii) and (iv) continue to apply to currency and accounts payable and receivable, respectively.

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the final rule does not impose a collection of information on small entities, the provisions of the Regulatory Flexibility Act do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

DRAFTING INFORMATION: The principal authors of these final regulations are John W. Rogers III of the Office of the Associate Chief Counsel (International) and Thomas Preston of the Office of Associate Chief Counsel (Financial Institutions and Products). Other personnel from the IRS and Treasury

Department also participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§1.985-1 [Amended]

Par. 2. In §1.985-1, paragraph (c)(6), in the last sentence, the reference “§1.985-8T” is removed and “§1.985-8” is added in its place.

§1.985-4 [Amended]

Par. 3. In §1.985-4, paragraph (a), in the last sentence, the reference “§1.985-8T” is removed and “§1.985-8” is added in its place.

Par. 4. Section 1.985-8 is added to read as follows:

§1.985-8 Special rules applicable to the European Monetary Union (conversion to euro).

(a) *Definitions*—(1) *Legacy currency*. A legacy currency is the former currency of a Member State of the European Community which is substituted for the euro in accordance with the Treaty establishing the European Community signed February 7, 1992. The term legacy currency shall also include the European Currency Unit.

(2) *Conversion rate*. The conversion rate is the rate at which the euro is substituted for a legacy currency.

(b) *Operative rules*—(1) *Initial adoption*. A QBU (as defined in §1.989(a)-1(b)) whose first taxable year begins after the euro has been substituted for a legacy currency may not adopt a legacy currency as its functional currency.

(2) *QBU with a legacy currency as its functional currency*—(i) *Required change*. A QBU with a legacy currency as its functional currency is required to change its functional currency to the euro beginning the first day of the first taxable year—

(A) That begins on or after the day that the euro is substituted for that legacy currency (in accordance with the Treaty on European Union); and

(B) In which the QBU begins to maintain its books and records (as described in §1.989(a)-1(d)) in the euro.

(ii) Notwithstanding paragraph (b)(2)(i) of this section, a QBU with a legacy currency as its functional currency is required to change its functional currency to the euro no later than the last taxable year beginning on or before the first day such legacy currency is no longer valid legal tender.

(3) *QBU with a non-legacy currency as its functional currency*—(i) *In general*. A QBU with a non-legacy currency as its functional currency may change its functional currency to the euro pursuant to this §1.985-8 if—

(A) Under the rules set forth in §1.985-1(c), the euro is the currency of the economic environment in which a significant part of the QBU's activities are conducted;

(B) After conversion, the QBU maintains its books and records (as described in §1.989(a)-1(d)) in the euro; and

(C) The QBU is not required to use the dollar as its functional currency under §1.985-1(b).

(ii) *Time period for change*. A QBU with a non-legacy currency as its functional currency may change its functional currency to the euro under this section only if it does so within the period set forth in paragraph (b)(2) of this section as if the functional currency of the QBU was a legacy currency.

(4) *Consent of Commissioner*. A change made pursuant to paragraph (b) of this section shall be deemed to be made with the consent of the Commissioner for purposes of §1.985-4. A QBU changing its functional currency to the euro pursuant to paragraph (b)(2) of this section must make adjustments as provided in paragraph (c) of this section. A QBU changing its functional currency to the euro pursuant to paragraph (b)(3) must make adjustments as provided in §1.985-5.

(5) *Statement to file upon change*. With respect to a QBU that changes its functional currency to the euro under paragraph (b) of this section, an affected taxpayer shall attach to its return for the taxable year of change a statement that

includes the following: “TAXPAYER CERTIFIES THAT A QBU OF THE TAXPAYER HAS CHANGED ITS FUNCTIONAL CURRENCY TO THE EURO PURSUANT TO TREAS. REG. §1.985-8.” For purposes of this paragraph (b)(5), an affected taxpayer shall be in the case where the QBU is: a QBU of an individual U.S. resident (as a result of the activities of such individual), the individual; a QBU branch of a U.S. corporation, the corporation; a controlled foreign corporation (as described in section 957)(or QBU branch thereof), each United States shareholder (as described in section 951(b)); a partnership, each partner separately; a noncontrolled section 902 corporation (as described in section 904(d)(2)(E)) (or branch thereof), each domestic shareholder as described in §1.902-1(a)(1); or a trust or estate, the fiduciary of such trust or estate.

(c) *Adjustments required when a QBU changes its functional currency from a legacy currency to the euro pursuant to paragraph (b)(2) of this section*—(1) *In general*. A QBU that changes its functional currency from a legacy currency to the euro pursuant to paragraph (b)(2) of this section must make the adjustments described in paragraphs (c)(2) through (5) of this section. Section 1.985-5 shall not apply.

(2) *Determining the euro basis of property and the euro amount of liabilities and other relevant items*. The euro basis in property and the euro amount of liabilities and other relevant items shall equal the product of the legacy functional currency adjusted basis or amount of liabilities multiplied by the applicable conversion rate.

(3) *Taking into account exchange gain or loss on legacy currency section 988 transactions*—(i) *In general*. Except as provided in paragraphs (c)(3)(iii) and (iv) of this section, a legacy currency denominated section 988 transaction (determined after applying section 988(d)) outstanding on the last day of the taxable year immediately prior to the year of change shall continue to be treated as a section 988 transaction after the change and the principles of section 988 shall apply.

(ii) *Examples*. The application of this paragraph (c)(3) may be illustrated by the following examples:

Example 1. X, a calendar year QBU on the cash method of accounting, uses the deutschmark as its functional currency. X is not described in section 1281(b). On July 1, 1998, X converts 10,000 deutschmarks (DM) into Dutch guilders (fl) at the spot rate of fl1 = DM1 and loans the 10,000 guilders to Y (an unrelated party) for one year at a rate of 10% with principal and interest to be paid on June 30, 1999. On January 1, 1999, X changes its functional currency to the euro pursuant to this section. Assume that the euro/deutschmark conversion rate is set by the European Council at €1 = DM2. Assume further that the euro/guilder conversion rate is set at €1 = fl2.25. Accordingly, under the terms of the note, on June 30, 1999, X will receive € 4444.44 (fl10,000/2.25) of principal and € 444.44 (fl1,000/2.25) of interest. Pursuant to this paragraph (c)(3), X will realize an exchange loss on the principal computed under the principles of §1.988-2(b)(5). For this purpose, the exchange rate used under §1.988-2(b)(5)(i) shall be the guilder/euro conversion rate. The amount under §1.988-2(b)(5)(ii) is determined by translating the fl10,000 at the guilder/deutschmark spot rate on July 1, 1998, and translating that deutschmark amount into euros at the deutschmark/euro conversion rate. Thus, X will compute an exchange loss for 1999 of € 555.56 determined as follows: [€ 4444.44 (fl10,000/2.25) - €5000 ((fl10,000/1)/2) = -€555.56]. Pursuant to this paragraph (c)(3), the character and source of the loss are determined pursuant to section 988 and regulations thereunder. Because X uses the cash method of accounting for the interest on this debt instrument, X does not realize exchange gain or loss on the receipt of that interest.

Example 2. (i) X, a calendar year QBU on the accrual method of accounting, uses the deutschmark as its functional currency. On February 1, 1998, X converts 12,000 deutschmarks into Dutch guilders at the spot rate of fl1 = DM1 and loans the 12,000 guilders to Y (an unrelated party) for one year at a rate of 10% with principal and interest to be paid on January 31, 1999. In addition, assume the average rate (deutschmark/guilder) for the period from February 1, 1998, through December 31, 1998 is fl1.07 = DM1. Pursuant to §1.988-2(b)(2)(ii)(C), X will accrue eleven months of interest on the note and recognize interest income of DM1028.04 (fl1100/1.07) in the 1998 taxable year.

(ii) On January 1, 1999, the euro will replace the deutschmark as the national currency of Germany pursuant to the Treaty on European Union signed February 7, 1992. Assume that on January 1, 1999, X changes its functional currency to the euro pursuant to this section. Assume that the euro/deutschmark conversion rate is set by the European Council at €1 = DM2. Assume further that the euro/guilder conversion rate is set at €1 = fl2.25. In 1999, X will accrue one month of interest equal to € 44.44 (fl100/2.25). On January 31, 1999, pursuant to the note, X will receive interest denominated in euros of € 533.33 (fl1200/2.25). Pursuant to this paragraph (c)(3), X will realize an exchange loss in the 1999 taxable year with respect to accrued interest computed under the principles of §1.988-2(b)(3). For this purpose, the exchange rate used under §1.988-2(b)(3)(i) is the guilder/euro conversion rate and the exchange rate used under §1.988-2(b)(3)(ii) is the deutschmark/euro conversion rate. Thus, with respect to the interest accrued

in 1998, X will realize exchange loss of € 25.13 under §1.988-2(b)(3) as follows: [€ 488.89 (fl1100/2.25) - € 514.02 (DM1028.04/2) = -€ 25.13]. With respect to the one month of interest accrued in 1999, X will realize no exchange gain or loss since the exchange rate when the interest accrued and the spot rate on the payment date are the same.

(iii) X will realize exchange loss of € 666.67 on repayment of the loan principal computed in the same manner as in Example 1 [€ 5333.33 (fl12,000/2.25) - € 6000 (fl12,000/1)/2)]. The losses with respect to accrued interest and principal are characterized and sourced under the rules of section 988.

(iii) *Special rule for legacy nonfunctional currency.* The QBU shall realize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to nonfunctional currency (as described in section 988(c)(1)(C)(ii)) that is denominated in a legacy currency as if the currency were disposed of on the last day of the taxable year immediately prior to the year of change. The character and source of the gain or loss are determined under section 988.

(iv) *Legacy currency denominated accounts receivable and payable—(A) In general.* A QBU may elect to realize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to a legacy currency denominated item described in section 988(c)(1)(B)(ii) as if the item were terminated on the last day of the taxable year ending prior to the year of change.

(B) *Time and manner of election.* With respect to a QBU that makes an election described in paragraph (c)(3)(iv)(A) of this section, an affected taxpayer (as described in paragraph (b)(5) of this section) shall attach a statement to its tax return for the taxable year ending immediately prior to the year of change which includes the following: “TAXPAYER CERTIFIES THAT A QBU OF THE TAXPAYER HAS ELECTED TO REALIZE CURRENCY GAIN OR LOSS ON LEGACY CURRENCY DENOMINATED ACCOUNTS RECEIVABLE AND PAYABLE UPON CHANGE OF FUNCTIONAL CURRENCY TO THE EURO.” A QBU making the election must do so for all legacy currency denominated items described in section 988(c)(1)(B)(ii).

(4) *Adjustments when a branch changes its functional currency to the euro—(i)*

Branch changing from a legacy currency to the euro in a taxable year during which taxpayer’s functional currency is other than the euro. If a branch changes its functional currency from a legacy currency to the euro for a taxable year during which the taxpayer’s functional currency is other than the euro, the branch’s euro equity pool shall equal the product of the legacy currency amount of the equity pool multiplied by the applicable conversion rate. No adjustment to the basis pool is required.

(ii) *Branch changing from a legacy currency to the euro in a taxable year during which taxpayer’s functional currency is the euro.* If a branch changes its functional currency from a legacy currency to the euro for a taxable year during which the taxpayer’s functional currency is the euro, the taxpayer shall realize gain or loss attributable to the branch’s equity pool under the principles of section 987, computed as if the branch terminated on the last day prior to the year of change. Adjustments under this paragraph (c)(4)(ii) shall be taken into account by the taxpayer ratably over four taxable years beginning with the taxable year of change.

(5) *Adjustments to a branch’s accounts when a taxpayer changes to the euro—(i) Taxpayer changing from a legacy currency to the euro in a taxable year during which a branch’s functional currency is other than the euro.* If a taxpayer changes its functional currency to the euro for a taxable year during which the functional currency of a branch of the taxpayer is other than the euro, the basis pool shall equal the product of the legacy currency amount of the basis pool multiplied by the applicable conversion rate. No adjustment to the equity pool is required.

(ii) *Taxpayer changing from a legacy currency to the euro in a taxable year during which a branch’s functional currency is the euro.* If a taxpayer changes its functional currency from a legacy currency to the euro for a taxable year during which the functional currency of a branch of the taxpayer is the euro, the taxpayer shall take into account gain or loss as determined under paragraph (c)(4)(ii) of this section.

(6) *Additional adjustments that are necessary when a corporation changes its functional currency to the euro.* The amount of a corporation’s euro currency earnings and profits and the amount of its

euro paid-in capital shall equal the product of the legacy currency amounts of these items multiplied by the applicable conversion rate. The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that were maintained in foreign currency for purposes of section 902 and that are attributable to taxable years of the foreign corporation beginning before January 1, 1987, also shall be translated into the euro at the conversion rate.

(d) *Treatment of legacy currency section 988 transactions with respect to a QBU that has the euro as its functional currency*—(1) *In general.* This §1.985–8(d) applies to a QBU that has the euro as its functional currency and that holds a section 988 transaction denominated in, or determined by reference to, a currency that is substituted by the euro. For example, this paragraph (d) will apply to a German QBU with the euro as its functional currency if the QBU is holding Country X currency or other section 988 transactions denominated in such currency on the day in the year 2005 when the euro is substituted for the Country X currency.

(2) *Principles of paragraph (c)(3) of this section shall apply.* With respect to a QBU described in paragraph (d) of this section, the principles of paragraph (c)(3) of this section shall apply. For example, if a German QBU with the euro as its functional currency is holding a Country X currency denominated debt instrument on the day in the year 2005 when the euro is substituted for the Country X currency, the instrument shall continue to be treated as a section 988 transaction pursuant to the principles of paragraph (c)(3)(i) of this section. However, if such QBU holds Country X currency, the QBU shall take into account any unrealized exchange gain or loss pursuant to the principles of paragraph (c)(3)(iii) of this section as if the currency was disposed of on the day prior to the day the euro is substituted for the Country X currency. Similarly, if the QBU makes an election under the principles of paragraph (c)(3)(iv) of this section,

the QBU shall take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to a legacy currency denominated item described in section 988(c)(1)(B)(ii) as if the item were terminated on the day prior to the day the euro is substituted for the Country X currency.

(e) *Effective date.* This section applies to tax years ending after July 29, 1998.

§1.985–8T [Removed]

Par.5. Section 1.985–8T is removed.

Par.6. Section 1.1001–5 is added to read as follows:

§1.1001–5 European Monetary Union (conversion to the euro).

(a) *Conversion of currencies.* For purposes of §1.1001–1(a), the conversion to the euro of legacy currencies (as defined in §1.985–8(a)(1)) is not the exchange of property for other property differing materially in kind or extent.

(b) *Effect of currency conversion on other rights and obligations.* For purposes of §1.1001–1(a), if, solely as the result of the conversion of legacy currencies to the euro, rights or obligations denominated in a legacy currency become rights or obligations denominated in the euro, that event is not the exchange of property for other property differing materially in kind or extent. Thus, for example, when a debt instrument that requires payments of amounts denominated in a legacy currency becomes a debt instrument requiring payments of euros, that alteration is not a modification within the meaning of §1.1001–3(c).

(c) *Effective date.* This section applies to tax years ending after July 29, 1998.

§1.1001–5T [Removed]

Par. 7. Section 1.1001–5T is removed.

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

Approved December 12, 2000.

Jonathan Talisman,
Acting Assistant Secretary
of the Treasury.

(Filed by the Office of the Federal Register on January 10, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 11, 2001, 66 F.R. 2215)

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate; and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for March 2001.

Rev. Rul. 2001–12

This revenue ruling provides various prescribed rates for federal income tax purposes for March 2001 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2001-12 TABLE 1

Applicable Federal Rates (AFR) for March 2001

Period for Compounding

	<i>Annual</i>	<i>Semiannual</i>	<i>Quarterly</i>	<i>Monthly</i>
<i>Short-Term</i>				
AFR	4.86%	4.80%	4.77%	4.75%
110% AFR	5.35%	5.28%	5.25%	5.22%
120% AFR	5.84%	5.76%	5.72%	5.69%
130% AFR	6.34%	6.24%	6.19%	6.16%
<i>Mid-Term</i>				
AFR	5.07%	5.01%	4.98%	4.96%
110% AFR	5.59%	5.51%	5.47%	5.45%
120% AFR	6.10%	6.01%	5.97%	5.94%
130% AFR	6.62%	6.51%	6.46%	6.42%
150% AFR	7.66%	7.52%	7.45%	7.40%
175% AFR	8.96%	8.77%	8.68%	8.61%
<i>Long-Term</i>				
AFR	5.58%	5.50%	5.46%	5.44%
110% AFR	6.14%	6.05%	6.00%	5.98%
120% AFR	6.71%	6.60%	6.55%	6.51%
130% AFR	7.28%	7.15%	7.09%	7.05%

REV. RUL. 2001-12 TABLE 2

Adjusted AFR for March 2001

Period for Compounding

	<i>Annual</i>	<i>Semiannual</i>	<i>Quarterly</i>	<i>Monthly</i>
Short-term adjusted AFR	3.44%	3.41%	3.40%	3.39%
Mid-term adjusted AFR	3.98%	3.94%	3.92%	3.91%
Long-term adjusted AFR	4.87%	4.81%	4.78%	4.76%

REV. RUL. 2001-12 TABLE 3

Rates Under Section 382 for March 2001

Adjusted federal long-term rate for the current month	4.87%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.24%

REV. RUL. 2001-12 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for March 2001

Appropriate percentage for the 70% present value low-income housing credit	8.24%
Appropriate percentage for the 30% present value low-income housing credit	3.53%

REV. RUL. 2001-12 TABLE 5

Rate Under Section 7520 for March 2001

Applicable federal rate for determining the present value of an annuity,
an interest for life or a term of years, or a remainder or reversionary interest

6.2%

Section 1288.—Treatment of Original Issue Discounts on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2001. See Rev. Rul. 2001-12 page 811.

Section 7502.—Timely Mailing Treated as Timely Filing and Paying

26 CFR 301.7502-1: *Timely mailing of documents and payments treated as timely filing and paying.*

T.D. 8932

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 301

Timely Mailing Treated as Timely Filing/Electronic Postmark

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations; and removal of temporary regulations.

SUMMARY: This document contains regulations relating to timely mailing treated as timely filing and paying under section 7502 of the Internal Revenue Code. The regulations generally reflect changes to the law made since 1960. In addition, the regulations provide that the date of an electronic postmark will be the filing date under certain circumstances. The regulations affect taxpayers who file documents or make payments or deposits.

DATES: *Effective Date:* These regulations are effective January 11, 2001.

Applicability Date: For dates of applicability, see §§301.7502-1(g) and 301.7502-2(e).

FOR FURTHER INFORMATION CONTACT: Charles A. Hall, (202) 622-4940 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Regulations on Procedure and Administration (26 CFR part 301) under section 7502 relating to timely mailing treated as timely filing and paying. A notice of proposed rulemaking (REG-115433-98, 1999-1 C.B. 651) was published in the **Federal Register** (64 F.R. 2606) on January 15, 1999. Temporary regulations (T.D. 8807, 1999-1 C.B. 630) relating to electronic postmarks for electronically filed income tax returns were published in the **Federal Register** for the same day (64 F.R. 2568). No public hearing was requested or held. No comments were received from the public in response to the notice of proposed rulemaking. The proposed regulations under section 7502 are adopted as revised by this Treasury decision and the corresponding temporary regulations are removed. The revisions are discussed below.

Explanation of Revisions

In the notice of proposed rulemaking, the IRS and the Treasury Department requested comments regarding whether section 7502 should apply to claims for credit or refund made on late filed original income tax returns. No comments were received on this issue. However, the IRS and the Treasury Department have determined that, in certain situations, a claim for credit or refund made on a late filed original income tax return should be treated under section 7502 as timely filed on the postmark date for purposes of section 6511(b)(2)(A). This is consistent with the

opinion of the United States Court of Appeals for the Second Circuit in *Weisbart v. United States Department of Treasury and Internal Revenue Service*, 222 F.3d 93 (2d Cir. 2000), *rev'g* 99-1 USTC (CCH) ¶ 50,549 (E.D.N.Y. 1999), AOD-CC-2000-09 (Nov. 13, 2000).

The IRS and the Treasury Department have further determined that claims for credit or refund made on late filed original tax returns other than income tax returns should also be treated under section 7502 as timely filed on the postmark date for purposes of section 6511(b)(2)(A). This would include returns such as Form 720, *Quarterly Federal Excise Tax Return*, and Form 706, *U.S. Estate Tax Return*. Moreover, the IRS and the Treasury Department have determined that the late filed original tax return, as well as the claim for credit or refund, should also be treated as filed on the postmark date. These changes, which are reflected in §301.7502-1(f), will assist taxpayers in filing timely claims for credit or refund, and will be applied retroactively to certain previously disallowed claims for credit or refund.

These changes are effective for any claim for credit or refund on a late filed tax return described in §301.7502-1(f)(1) except for those claims for credit or refund which (without regard to paragraph (f) of this section) were barred by the operation of section 6532(a) or any other law or rule of law (including *res judicata*) as of January 11, 2001. See §301.7502-1(g)(2), which provides the effective date rules for §301.7502-1(f).

Consistent with the effective date rules for §301.7502-1(f), the IRS will attempt to identify as many claims as possible that were filed on untimely original individual income tax returns and that were previously disallowed based on the Government's position in *Weisbart*. In

these cases, the IRS intends to issue a refund, or credit the overpayment against a liability as provided in section 6402, without the need for the taxpayer to contact the IRS. Such automatic reconsideration of the claim will generally occur if the claim was filed on an individual income tax return for 1995 or a subsequent calendar year. Claims filed on other types of original returns will not receive automatic reconsideration under this program, e.g., individual returns for years prior to 1995.

Because the IRS will be undertaking the automatic reconsideration program described above and intends to complete the program by June 30, 2001, taxpayers who have filed income tax refund claims for tax year 1995 and later years that qualify under §301.7502-1(f) need not contact the IRS regarding their claims unless the two-year period for filing a refund suit under section 6532(a) for their denied claim will expire prior to June 30, 2001. In such cases, taxpayers are advised to file a request for reconsideration with the appropriate IRS Service Center. Such a request should include a notation on the top of the first page that it is a “Weisbart Claim.” Such taxpayers are also advised to file a refund suit to protect their legal rights with respect to the claim. The IRS will respond to the requests for reconsideration after the IRS has finished identifying eligible claims under the automatic reconsideration program and paying those refunds. Taxpayers whose two-year period for filing a refund suit under section 6532(a) does not expire until after June 30, 2001, and who have not received a refund by that date, are advised to file a request for reconsideration with the appropriate IRS Service Center at that time.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility

Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Charles A. Hall of the Office of Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice Division). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 301.7502-1 also issued under 26 U.S.C. 7502.

Section 301.7502-2 also issued under 26 U.S.C. 7502. * * *

Par. 2. Section 301.7502-1 is revised to read as follows:

§301.7502-1 Timely mailing of documents and payments treated as timely filing and paying.

(a) *General rule.* Section 7502 provides that, if the requirements of that section are met, a document or payment is deemed to be filed or paid on the date of the postmark stamped on the envelope or other appropriate wrapper (envelope) in which the document or payment was mailed. Thus, if the envelope that contains the document or payment has a timely postmark, the document or payment is considered timely filed or paid even if it is received after the last date, or the last day of the period, prescribed for filing the document or making the payment. Section 7502 does not apply in determining whether a failure to file a return or pay a tax has continued for an additional month or fraction thereof for purposes of

computing the penalties and additions to tax imposed by section 6651. Except as provided in section 7502(e) and §301.7502-2, relating to the timely mailing of deposits, and paragraph (d) of this section, relating to electronically filed documents, section 7502 is applicable only to those documents or payments as defined in paragraph (b) of this section and only if the document or payment is mailed in accordance with paragraph (c) of this section and is delivered in accordance with paragraph (e) of this section.

(b) *Definitions*—(1) *Document defined.* (i) The term *document*, as used in this section, means any return, claim, statement, or other document required to be filed within a prescribed period or on or before a prescribed date under authority of any provision of the internal revenue laws, except as provided in paragraph (b)(1)(ii), (iii), or (iv) of this section.

(ii) The term does not include returns, claims, statements, or other documents that are required under any provision of the internal revenue laws or the regulations thereunder to be delivered by any method other than mailing.

(iii) The term does not include any document filed in any court other than the Tax Court, but the term does include any document filed with the Tax Court, including a petition and a notice of appeal of a decision of the Tax Court.

(iv) The term does not include any document that is mailed to an authorized financial institution under section 6302. However, see §301.7502-2 for special rules relating to the timeliness of deposits and documents required to be filed with deposits.

(2) *Claims for refund.* In the case of certain taxes, a return may constitute a claim for credit or refund. In such a case, section 7502 is applicable to the claim for credit or refund if the conditions of such section are met, irrespective of whether the claim is also a return. For rules regarding claims for refund on late filed tax returns, see paragraph (f) of this section.

(3) *Payment defined.* (i) The term *payment*, as used in this section, means any payment required to be made within a prescribed period or on or before a prescribed date under the authority of any provision of the internal revenue laws, except as provided in paragraph (b)(3)(ii), (iii), (iv), or (v) of this section.

(ii) The term does not include any payment that is required under any provision of the internal revenue laws or the regulations thereunder to be delivered by any method other than mailing. See, for example, section 6302(h) and the regulations thereunder regarding electronic funds transfer.

(iii) The term does not include any payment, whether it is made in the form of currency or other medium of payment, unless it is actually received and accounted for. For example, if a check is used as the form of payment, this section does not apply unless the check is honored upon presentation.

(iv) The term does not include any payment to any court other than the Tax Court.

(v) The term does not include any deposit that is required to be made with an authorized financial institution under section 6302. However, see §301.7502-2 for rules relating to the timeliness of deposits.

(4) *Last date or last day prescribed.* As used in this section, the term *the last date, or the last day of the period, prescribed for filing the document or making the payment* includes any extension of time granted for that action. When the last date, or the last day of the period, prescribed for filing the document or making the payment falls on a Saturday, Sunday or legal holiday, section 7503 applies. Therefore, in applying the rules of this paragraph (b)(4), the next succeeding day that is not a Saturday, Sunday, or legal holiday is treated as the last date, or the last day of the period, prescribed for filing the document or making the payment. Also, when the last date, or the last day of the period, prescribed for filing the document or making the payment falls within a period disregarded under section 7508 or section 7508A, the next succeeding day after the expiration of the section 7508 period or section 7508A period that is not a Saturday, Sunday, or legal holiday is treated as the last date, or the last day of the period, prescribed for filing the document or making the payment.

(c) *Mailing requirements*—(1) *In general.* Section 7502 does not apply unless the document or payment is mailed in accordance with the following requirements:

(i) *Envelope and address.* The document or payment must be contained in an

envelope, properly addressed to the agency, officer, or office with which the document is required to be filed or to which the payment is required to be made.

(ii) *Timely deposited in U.S. mail.* The document or payment must be deposited within the prescribed time in the mail in the United States with sufficient postage prepaid. For this purpose, a document or payment is deposited in the mail in the United States when it is deposited with the domestic mail service of the U.S. Postal Service. The domestic mail service of the U.S. Postal Service, as defined by the Domestic Mail Manual as incorporated by reference in the postal regulations, includes mail transmitted within, among, and between the United States of America, its territories and possessions, and Army post offices (APO), fleet post offices (FPO), and the United Nations, NY. (See Domestic Mail Manual, section G011.2.1, as incorporated by reference in 39 CFR 111.1.) Section 7502 does not apply to any document or payment that is deposited with the mail service of any other country.

(iii) *Postmark*—(A) *U.S. Postal Service postmark.* If the postmark on the envelope is made by the U.S. Postal Service, the postmark must bear a date on or before the last date, or the last day of the period, prescribed for filing the document or making the payment. If the postmark does not bear a date on or before the last date, or the last day of the period, prescribed for filing the document or making the payment, the document or payment is considered not to be timely filed or paid, regardless of when the document or payment is deposited in the mail. Accordingly, the sender who relies upon the applicability of section 7502 assumes the risk that the postmark will bear a date on or before the last date, or the last day of the period, prescribed for filing the document or making the payment. See, however, paragraph (c)(2) of this section with respect to the use of registered mail or certified mail to avoid this risk. If the postmark on the envelope is made by the U.S. Postal Service but is not legible, the person who is required to file the document or make the payment has the burden of proving the date that the postmark was made. Furthermore, if the envelope that contains a document or payment has a timely postmark made by the U.S. Postal

Service, but it is received after the time when a document or payment postmarked and mailed at that time would ordinarily be received, the sender may be required to prove that it was timely mailed.

(B) *Postmark made by other than U.S. Postal Service*—(1) *In general.* If the postmark on the envelope is made other than by the U.S. Postal Service—

(i) The postmark so made must bear a legible date on or before the last date, or the last day of the period, prescribed for filing the document or making the payment; and

(ii) The document or payment must be received by the agency, officer, or office with which it is required to be filed not later than the time when a document or payment contained in an envelope that is properly addressed, mailed, and sent by the same class of mail would ordinarily be received if it were postmarked at the same point of origin by the U.S. Postal Service on the last date, or the last day of the period, prescribed for filing the document or making the payment.

(2) *Document or payment received late.* If a document or payment described in paragraph (c)(1)(iii)(B)(1) is received after the time when a document or payment so mailed and so postmarked by the U.S. Postal Service would ordinarily be received, the document or payment is treated as having been received at the time when a document or payment so mailed and so postmarked would ordinarily be received if the person who is required to file the document or make the payment establishes—

(i) That it was actually deposited in the U.S. mail before the last collection of mail from the place of deposit that was postmarked (except for the metered mail) by the U.S. Postal Service on or before the last date, or the last day of the period, prescribed for filing the document or making the payment;

(ii) That the delay in receiving the document or payment was due to a delay in the transmission of the U.S. mail; and

(iii) The cause of the delay.

(3) *U.S. and non-U.S. postmarks.* If the envelope has a postmark made by the U.S. Postal Service in addition to a postmark not so made, the postmark that was not made by the U.S. Postal Service is disregarded, and whether the envelope was mailed in accordance with this paragraph

(c)(1)(iii)(B) will be determined solely by applying the rule of paragraph (c)(1)(iii)(A) of this section.

(2) *Registered or certified mail.* If the document or payment is sent by U.S. registered mail, the date of registration of the document or payment is treated as the postmark date. If the document or payment is sent by U.S. certified mail and the sender's receipt is postmarked by the postal employee to whom the document or payment is presented, the date of the U.S. postmark on the receipt is treated as the postmark date of the document or payment. Accordingly, the risk that the document or payment will not be postmarked on the day that it is deposited in the mail may be eliminated by the use of registered or certified mail.

(d) *Electronically filed documents*—(1) *In general.* A document filed electronically with an electronic return transmitter (as defined in paragraph (d)(3)(i) of this section and authorized pursuant to paragraph (d)(2) of this section) in the manner and time prescribed by the Commissioner is deemed to be filed on the date of the electronic postmark (as defined in paragraph (d)(3)(ii) of this section) given by the authorized electronic return transmitter. Thus, if the electronic postmark is timely, the document is considered filed timely although it is received by the agency, officer, or office after the last date, or the last day of the period, prescribed for filing such document.

(2) *Authorized electronic return transmitters.* The Commissioner may enter into an agreement with an electronic return transmitter or prescribe in forms, instructions, or other appropriate guidance the procedures under which the electronic return transmitter is authorized to provide taxpayers with an electronic postmark to acknowledge the date and time that the electronic return transmitter received the electronically filed document.

(3) *Definitions*—(i) *Electronic return transmitter.* For purposes of this paragraph (d), the term *electronic return transmitter* has the same meaning as contained in section 3.01(4) of Rev. Proc. 2000-31 (2000-31 I.R.B. 146 (July 31, 2000))(see §601.601(d)(2) of this chapter) or in procedures prescribed by the Commissioner.

(ii) *Electronic postmark.* For purposes of this paragraph (d), the term *electronic*

postmark means a record of the date and time (in a particular time zone) that an authorized electronic return transmitter receives the transmission of a taxpayer's electronically filed document on its host system. However, if the taxpayer and the electronic return transmitter are located in different time zones, it is the taxpayer's time zone that controls the timeliness of the electronically filed document.

(e) *Delivery*—(1) Except as provided in section 7502(f) and paragraph (d) of this section, section 7502 is not applicable unless the document or payment is delivered by U.S. mail to the agency, officer, or office with which the document is required to be filed or to which payment is required to be made. However, in the case of a document (but not a payment) sent by registered or certified mail, proof that the document was properly registered or that a postmarked certified mail sender's receipt was properly issued and that the envelope was properly addressed to the agency, officer, or office constitutes *prima facie* evidence that the document was delivered to the agency, officer, or office.

(2) Section 7502 is applicable to the determination of whether a claim for credit or refund is timely filed for purposes of section 6511(a), assuming all the requirements of section 7502 are satisfied. Section 7502 is also applicable when a claim for credit or refund is delivered after the last day of the period specified in section 6511(b)(2)(A) or in any other corresponding provision of law relating to the limit on the amount of credit or refund that is allowable.

(3) *Example.* The rules of paragraph (e)(2) of this section are illustrated by the following example:

Example. (i) Taxpayer A, an individual, mailed his 1998 Form 1040, "U.S. Individual Income Tax Return," on May 10, 1999, but no tax was paid at that time because the tax liability disclosed by the return had been completely satisfied by the income tax that had been withheld on A's wages. On April 15, 2002, A mails in accordance with the requirements of this section, a Form 1040X, "U.S. Amended Individual Income Tax Return," claiming a refund of a portion of the tax that had been paid through withholding during 1998. The date of the postmark on the envelope containing the claim for refund is April 15, 2002. The claim is received by the Internal Revenue Service (IRS) on April 18, 2002.

(ii) Under section 6511(a), A's claim for refund is timely if filed within three years from May 10, 1999, the date on which A's 1998 return was filed. However, as a result of the limitations of section

6511(b)(2)(A), if his claim is not filed within three years after April 15, 1999, the date on which he is deemed under section 6513 to have paid his 1998 tax, he is not entitled to any refund. Thus, because A's claim for refund is postmarked and mailed in accordance with the requirements of this section and is delivered after the last day of the period specified in section 6511(b)(2)(A), section 7502 is applicable and the claim is deemed to have been filed on April 15, 2002.

(f) *Claim for credit or refund on late filed tax return*—(1) *In general.* Generally, an original income tax return may constitute a claim for credit or refund of income tax. See §301.6402-3(a)(5). Other original tax returns can also be considered claims for credit or refund if the liability disclosed on the return is less than the amount of tax that has been paid. If section 7502 would not apply to a return (but for the operation of paragraph (f)(2) of this section) that is also considered a claim for credit or refund because the envelope that contains the return does not have a postmark dated on or before the due date of the return, section 7502 will apply separately to the claim for credit or refund if—

(i) The date of the postmark on the envelope is within the period that is three years (plus the period of any extension of time to file) from the day the tax is paid or considered paid (see section 6513), and the claim for credit or refund is delivered after this three-year period; and

(ii) The conditions of section 7502 are otherwise met.

(2) *Filing date of late filed return.* If the conditions of paragraph (f)(1) of this section are met, the late filed return will be deemed filed on the postmark date.

(3) *Example.* The rules of this paragraph (f) are illustrated by the following example:

Example. (i) Taxpayer A, an individual, mailed his 2001 Form 1040, "U.S. Individual Income Tax Return," on April 15, 2005, claiming a refund of amounts paid through withholding during 2001. The date of the postmark on the envelope containing the return and claim for refund is April 15, 2005. The return and claim for refund are received by the Internal Revenue Service (IRS) on April 18, 2005. Amounts withheld in 2001 exceeded A's tax liability for 2001 and are treated as paid on April 15, 2002, pursuant to section 6513.

(ii) Even though the date of the postmark on the envelope is after the due date of the return, the claim for refund and the late filed return are treated as filed on the postmark date for purposes of this paragraph (f). Accordingly, the return will be treated as filed on April 15, 2005. In addition, the claim for refund will be treated as timely filed on April 15, 2005. Further, the entire amount of the refund attributable to with-

holding is allowable as a refund under section 6511(b)(2)(A).

(g) *Effective date*—(1) *In general.* Except as provided in paragraphs (g)(2) and (3) of this section, the rules of this section apply to any payment or document mailed and delivered in accordance with the requirements of this section in an envelope bearing a postmark dated after January 11, 2001.

(2) *Claim for credit or refund on late filed tax return.* Paragraph (f) of this section applies to any claim for credit or refund on a late filed tax return described in paragraph (f)(1) of this section except for those claims for credit or refund which (without regard to paragraph (f) of this section) were barred by the operation of section 6532(a) or any other law or rule of law (including *res judicata*) as of January 11, 2001.

(3) *Electronically filed documents.* This section applies to any electronically filed return, claim, statement, or other document transmitted to an electronic return transmitter that is authorized to provide an electronic postmark pursuant to paragraph (d)(2) of this section after January 11, 2001.

§301.7502-1T [Removed]

Par. 3. Section 301.7502-1T is removed.

Par. 4. Section 301.7502-2 is added to read as follows:

§301.7502-2 Timely mailing of deposits.

(a) *General rule*—(1) *Two day rule.* Section 7502(e) provides that, if the requirements of that section are met, a deposit is deemed to be received on the date the deposit was mailed even though it is received after the date prescribed for making the deposit. The requirements of the section are met if the person required to make the deposit establishes that the date of mailing was on or before the second day preceding the date prescribed for making the deposit. If the date of mailing was not established to be on or before the second day preceding the date prescribed

for making the deposit, the deposit will not be considered timely received unless it is actually received on or before the date prescribed for making the deposit. Section 7502(e) only applies to a deposit mailed to the financial institution authorized to receive that deposit. Thus, section 7502(e) does not apply to any remittance mailed to an internal revenue service center.

(2) *Deposits of \$20,000 or more.* Paragraph (a)(1) of this section does not apply with respect to any deposit of \$20,000 or more by any person required to deposit any tax more than once a month. Any such deposit must be made by the due date for such deposit, regardless of the method of delivery.

(b) *Deposit defined.* The term *deposit*, as used in this section, means any deposit of tax required to be made on or before a prescribed date at an authorized financial institution pursuant to regulations prescribed under section 6302.

(c) *Mailing requirements*—(1) *In general.* Section 7502(e) does not apply unless the deposit is mailed in accordance with the requirements of paragraph (c)(2) of this section.

(2) *Requirements.* The date of mailing must fall on or before the second day preceding the prescribed date for making a deposit (including any extension of time granted for making the deposit). For example, if a deposit is due on or before January 15, the date of mailing must fall on or before January 13. The deposit must be contained in an envelope or other appropriate wrapper approved for use in the mails by the U.S. Postal Service, properly addressed to the financial institution authorized to receive the deposit. The deposit must be deposited with sufficient postage prepaid in the mail in the United States within the meaning of §301.7502-1 on or before the second day preceding the prescribed date for making a deposit.

(3) *Registered and certified mail.* The provisions of §301.7502-1(c)(2) apply to a deposit sent by U.S. registered mail or U.S. certified mail as if the deposit were a

payment, except that the date of registration or the date of the postmark on the sender's receipt is considered the date of mailing of such deposit.

(d) *Delivery.* Section 7502(e) does not apply unless a deposit is actually delivered by U.S. mail to the authorized financial institution with which the deposit is required to be made and is accepted by that financial institution. For rules relating to the acceptance of deposits by authorized financial institutions see 31 CFR 203.18. The fact that a deposit is sent by U.S. registered or U.S. certified mail does not constitute *prima facie* evidence that the deposit was delivered to the financial institution authorized to receive the deposit. Section 7502(e) does not apply unless the deposit is delivered after the date prescribed for making the deposit.

(e) *Effective date.* This section applies to all deposits required to be made after January 11, 2001.

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

Approved December 21, 2000.

Jonathan Talisman,
Acting Assistant Secretary
of the Treasury.

(Filed by the Office of the Federal Register on January 10, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 11, 2001, 66 F.R. 2257)

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2001. See Rev. Rul. 2001-12 page 811.

Section 7872.—Treatment of Loans with Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2001. See Rev. Rul. 2001-12 page 811.

Part III. Administrative, Procedural, and Miscellaneous

Weighted Average Interest Rate Update

Notice 2001-20

Notice 88-73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of

interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103-465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for January 2001 is 5.54 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 105% Permissible Range	90% to 110% Permissible Range
February	2001	5.89	5.30 to 6.19	5.30 to 6.48

Drafting Information

The principal author of this notice is Todd Newman of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please call Mr. Newman at (202) 283-9702 (not a toll-free number).

Low-Income Housing Tax Credit—2001 Calendar Year Resident Population Estimates

Notice 2001-21

This notice informs (1) state and local housing credit agencies that allocate low-income housing tax credits under § 42 of the Internal Revenue Code and (2) states

and other issuers of tax-exempt private activity bonds under § 141, of the proper population figures to be used for calculating the 2001 calendar year population-based component of the state housing credit ceiling (Credit Ceiling) under § 42(h)(3)(C)(ii) and the 2001 calendar year volume cap (Volume Cap) under § 146.

The population figures both for the population-based component of the Credit Ceiling and for the Volume Cap are determined by reference to § 146(j). That section provides generally that determinations of population for any calendar year are made on the basis of the most recent census estimate of the resident population of a state (or issuing authority) released by the Bureau of the Census before the beginning of such calendar year.

The proper population figures for calculating the Credit Ceiling and the Volume Cap for the 2001 calendar year are the resident population of the 50 states, the District of Columbia, and Puerto Rico, released by the Bureau of the Census on December 28, 2000, in Press Release CB00-CN.65. The proper population figures for calculating the Credit Ceiling and the Volume Cap for the 2001 calendar year for the insular areas (American Samoa, Guam, Northern Mariana Islands, and U.S. Virgin Islands) are the estimates of the resident population for July 1, 1999, released by the Bureau of the Census on December 29, 1999, in Press Release CB99-254. For convenience, the CB00-CN.65 and CB99-254 figures are reprinted below.

Resident Population Figures

Alabama	4,447,100
Alaska	626,932
American Samoa	63,781
Arizona	5,130,632
Arkansas	2,673,400
California	33,871,648
Colorado	4,301,261
Connecticut	3,405,565
Delaware	783,600
D.C.	572,059
Florida	15,982,378
Georgia	8,186,453
Guam	151,968
Hawaii	1,211,537

Resident Population Figures—cont.

Idaho	1,293,953
Illinois	12,419,293
Indiana	6,080,485
Iowa	2,926,324
Kansas	2,688,418
Kentucky	4,041,769
Louisiana	4,468,976
Maine	1,274,923
Maryland	5,296,486
Massachusetts	6,349,097
Michigan	9,938,444
Minnesota	4,919,479
Mississippi	2,844,658
Missouri	5,595,211
Montana	902,195
Nebraska	1,711,263
Nevada	1,998,257
New Hampshire	1,235,786
New Jersey	8,414,350
New Mexico	1,819,046
New York	18,976,457
North Carolina	8,049,313
North Dakota	642,200
Northern Mariana Islands	69,216
Ohio	11,353,140
Oklahoma	3,450,654
Oregon	3,421,399
Pennsylvania	12,281,054
Puerto Rico	3,808,610
Rhode Island	1,048,319
South Carolina	4,012,012
South Dakota	754,844
Tennessee	5,689,283
Texas	20,851,820
U.S. Virgin Islands	119,615
Utah	2,233,169
Vermont	608,827
Virginia	7,078,515
Washington	5,894,121
West Virginia	1,808,344
Wisconsin	5,363,675
Wyoming	493,782

The principal authors of this notice are Christopher J. Wilson of the Office of Associate Chief Counsel (Passthroughs

and Special Industries) and Timothy L. Jones of the Office of Associate Chief Counsel (Tax Exempt and Government

Entities). For further information regarding this notice contact Mr. Wilson at (202) 622-3040 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Source of Income From Certain Space and Ocean Activities; Also, Source of Communications Income

REG-106030-98

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations under section 863(d) governing the source of income from certain space and ocean activities. It also contains proposed regulations under sections 863(a), (d), and (e) governing the source of income from certain communications activity. This document also contains proposed regulations under sections 863(a) and (b), amending the regulations in §1.863-3 to conform those regulations with these proposed regulations. This document affects persons who conduct activities in space, or on or under water not within the jurisdiction of a foreign country, possession of the United States, or the United States (collectively, in international water). This document also affects persons who derive income from transmission of communications. In addition, this document provides notice of a public hearing on these proposed regulations.

DATES: Comments and outlines of oral comments to be presented at the public hearing scheduled for March 28, 2001, at 10 a.m. must be received by March 7, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (Reg-106030-98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG-106030-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by

selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.ustreas.gov/tax_regs/regslst.html. The public hearing will be held in the auditorium, seventh floor, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Anne Shelburne, (202) 874-1490; concerning submissions and the hearing, and/or to be placed on the building access list to attend the hearing, La Nita Van Dyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)).

Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S:O, Washington, DC 20224. Comments on the collection of information should be received by April 17, 2001. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information requirements are in proposed §1.863-8(g) and in §1.863-9(g). This information is required by the IRS to monitor compliance with the federal tax rules for determining the source of income from space or ocean activities, or from transmission of communications. The likely respondents are taxpayers who conduct space or ocean activities, or who derive communications income. Responses to this collection of information are required to properly determine the source of a taxpayer's income from such transactions.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Estimated total annual reporting/record-keeping burden: 1,200 hours. The estimated annual burden per respondent varies from 3 hours to 7 hours, depending on individual circumstances, with an estimated average of 5 hours.

Estimated number of respondents: 250

Estimated annual frequency of responses: One time per year.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

Background

This document contains proposed regulations relating to the Income Tax Regulations (CFR part 1) under sections 863(a), (b), (d), and (e) of the Internal Revenue Code (Code). Congress enacted section 863(d) and section 863(e) as part of the Tax Reform Act of 1986 (Public Law 99-514, 100 Stat. 2085) (the 1986 Act). Section 863(d) governs the source of income derived from certain space and ocean activities. Section 863(e) governs the source of income derived from international communications activity.

Explanation of Provisions

These proposed regulations provide two sets of rules, one in §1.863-8 for determining the source of income from space and ocean activities, the other in §1.863-9 for determining the source of income from communications activity. Section 1.863-9 provides rules for both international communications income (ICI) and other communications income. The IRS and Treasury believe it is appropriate to provide source rules for both ICI and other communications income in a single regulation.

The IRS and Treasury are fully aware of the rapid technological evolution in the space and communications industries since Congress enacted sections 863(d) and (e) in 1986, and have attempted to take into account these changes as well as changes in the space and communications industries and business practices and business models. The IRS and Treasury recognize that these regulations address important issues for many different industries and have worked closely with the industries in drafting these rules. The IRS and Treasury are interested in receiving comments from these industries on how to accommodate issues arising from the use of new technologies, consistent with the language and purpose of the statutory provisions.

A. Space and Ocean Activity Under Section 863(d)

1. Scope of §1.863-8 of the proposed regulations

Section 1.863-8 of the proposed regulations provides rules for sourcing income derived from space and ocean activity, notwithstanding other sections. Proposed regulations §1.863-8(a) provides that a taxpayer derives income from a space or ocean activity only if the taxpayer conducts such activity directly. This is consistent with the approach that IRS and Treasury adopted in the §1.863-3 regulations sourcing income from inventory sales.

2. Source of gross income from space or ocean activity

a. General

Section 863(d)(1) states that, except as provided in regulations, any income

derived from space or ocean activity by a U.S. person will be U.S. source income, and if derived by a foreign person, foreign source income. Proposed regulations §1.863-8(b)(1) provides that a U.S. person's space or ocean income is U.S. source. Proposed regulations §1.863-8(b)(1) also states the general rule that income derived by a foreign person from a space or ocean activity is foreign source income. However, the proposed regulations contain several exceptions to that general rule.

Proposed regulations §1.863-8(b)(2) provides that if a foreign corporation is 50 percent or more owned by vote or value (directly, indirectly, or constructively) by U.S. persons and is not a controlled foreign corporation within the meaning of section 957 (CFC), all income derived by the corporation from space or ocean activity is U.S. source income. This rule reflects IRS and Treasury's concern that U.S. persons may use a foreign corporation (for example, by incorporating a 50/50 joint venture with a foreign person, thereby avoiding CFC status) to obtain results that are inconsistent with the purposes of this section. The IRS and Treasury believe Congress granted Treasury broad regulatory authority in section 863(d) to prevent taxpayers from circumventing the purposes of this section.

Proposed regulations §1.863-8(b)(3) provides that if a foreign person is engaged in a U.S. trade or business, the foreign person's income derived from a space or ocean activity is presumed to be U.S. source income. The rule reflects IRS and Treasury's concern that a foreign person could engage in significant economic activities in the United States and avoid U.S. taxation of space or ocean income derived from such activities. For example, a foreign satellite company established in a no-tax jurisdiction could engage in substantial activity in the United States through launch facilities, yet pay no U.S. or foreign tax on income arising from leasing the satellites it launches. The IRS and Treasury believe Congress intended that a foreign person engaged in substantial U.S. business in the United States be subject to U.S. tax on related space or ocean activity.

The IRS and Treasury recognize that the presumption may be over-inclusive in

certain cases. Therefore, the proposed regulations provide that if the foreign person can allocate gross space or ocean income between income from sources within the United States, space, or international water, and outside the United States and space and international water, to the satisfaction of the Commissioner, based on the facts and circumstances, which may include functions performed, resources employed, risks assumed, or other contributions to value, income from outside the United States and space and international water will be treated as foreign source income. When a foreign person is entitled to the benefits of a tax treaty with the United States, such person may elect to be taxed under the rules of that treaty, so that, for example, the United States would tax only income attributable to a permanent establishment of that foreign person, regardless of the amount of income considered effectively connected with a U.S. trade or business.

b. Source Rules for Sales of Certain Property

Taxpayers must apply the rules of section 863(d) and these proposed regulations to determine the source of income from sales of property purchased or produced by the taxpayer, either when production occurs in whole or in part in space or in international water, or when the sale occurs in space or in international water. The rules of sections 861, 862, 863(a) and (b), and 865, and the regulations thereunder apply only to the extent provided in proposed regulations §1.863-8(b)(4).

Proposed regulations §1.863-8(b)(4)(i) provides that income derived from the sale of purchased property in space or international water is sourced under paragraph (b)(1), (2), or (3) of this section. Proposed regulations §1.863-8(d)(2)(iii) provides that a sale occurs in space or international water if either property is located in space or international water at the time the rights, title, and interests pass to the purchaser, or the property sold is for use in space or international water. This rule for determining if a sale takes place in space or in international water modifies for space and ocean activity the rule in §1.861-7(c) for otherwise determining where a sale takes place. The IRS and Treasury believe this rule for determining the place of sale in the case of space or

ocean activity is consistent with the legislative history of section 863(d), indicating Congress intended that space and ocean activity be broadly defined. See S. Rept. No. 313, 99th Cong., 2d Sess. 357 (1986) (Senate Report). It is also consistent with the language of the Senate Report stating that the committee did not intend to override the title passage rule for sales of property on the high seas. Consistent with this language, proposed regulations §1.863–8(d)(1)(ii) excludes from the definition of ocean activity the sale of inventory on international water, and the source of income from such sales continues to be determined under §1.861–7(c).

Proposed regulations §1.863–8(b)(4)(ii) provides rules for income derived from the sale of property produced by the taxpayer. To determine the source of income derived from the sale of property produced by the taxpayer, proposed regulations §1.863–8(b)(4)(ii)(A) provides that the taxpayer must divide gross income from such sale equally between production activity and sales activity. Thus, one-half of the taxpayer's gross income is attributed to production activity, and the other one-half of such gross income is attributed to sales activity.

Proposed regulations §1.863–8(b)(4)(ii)(A) provides that income attributable to sales activity is sourced applying the rules applicable to the sale of purchased property. If the taxpayer sells such property in space or international water, the source of income attributable to sales activity is determined under paragraph (b)(1), (2), or (3). If the taxpayer sells such property outside space and outside international water, the source of income attributable to sales activity is determined under §1.863–3(c)(2). Proposed regulations §1.863–8(b)(4)(ii)(B) provides that income attributable to production activity, when production occurs only in space or in international water, is sourced under paragraphs (b)(1), (2), or (3). When production occurs only outside space and international water, income attributable to production activity is sourced under §1.863–3(c)(1). When production activity occurs both in space or in international water and outside space and international water, proposed regulations §1.863–8(b)(4)(ii)(C) splits the income attributed to production activity between production

activities occurring in space or in international water, and production activities occurring outside space and international water. Gross income must be allocated to the satisfaction of the Commissioner, based on all relevant facts and circumstances, which may include functions performed, resources employed, risks assumed, and any other contributions to the value of the property. The source of gross income attributable to production activities in space or in international water is sourced under paragraphs (b)(1), (2), or (3). The source of gross income attributable to production activities outside space and international water is determined under §1.863–3(c)(1).

c. Special Rule for Determining the Source of Income from Services

Proposed regulations §1.863–8(b)(5) provides that income derived from the performance of services in space or in international water is sourced under paragraph (b)(1), (2), or (3). Proposed regulations §1.863–8(d)(2)(ii)(A) provides that a performance of a service is a space or ocean activity when a part of the service, even if *de minimis*, is performed in space or in international water. The IRS and Treasury believe that Congress intended a broad range of activities be treated as space or ocean activities.

The IRS and Treasury recognize that this rule may be over-inclusive in certain cases. Therefore, proposed regulations §1.863–8(b)(5) provides that the taxpayer can allocate gross income derived from the performance of the service between activities that occur in space or international water and activities that occur outside space and international water, to the satisfaction of the Commissioner, based on facts and circumstances, which may include functions performed, resources employed, risks assumed, or other contributions to value. Gross income allocated to activities occurring outside space and international water will be sourced under sections 861, 862, 863, and 865 of the Code.

d. Special Rule for Determining the Source of Communications Income

A communications activity, as defined in proposed regulations §1.863–9(d), also can be a space or ocean activity. Pursuant to the authority granted in section

863(d)(1), proposed regulations §1.863–8(b)(6) provides that income from communications activity that is also a space or ocean activity is sourced under proposed regulations §1.863–9(b).

3. Taxable income

When a taxpayer allocates gross income under paragraph (b)(3) (allocation for certain foreign persons), paragraph (b)(4)(ii)(C) (allocation between production occurring in space or international water and production occurring outside), or paragraph (b)(5) (allocation between services occurring in space or international water and those occurring outside) of this section, the taxpayer must allocate or apportion expenses, losses, and other deductions under §§1.861–8 through 1.861–14T of the regulations to the class of gross income, which must include the total income so allocated in each case. A taxpayer must then apply the rules of §§1.861–8 through 1.861–14T to properly allocate or apportion amounts of expenses, losses, and other deductions allocated or apportioned to such class of gross income between gross income from sources within the United States and without the United States.

When a taxpayer must allocate gross income to the satisfaction of the Commissioner based on the facts and circumstances, IRS and Treasury believe that such allocations would be based generally on section 482 principles. However, IRS and Treasury solicit comments on this approach, including specific comments and examples on alternative methods that could be used to make these allocations.

4. Definition of space and ocean activity

a. General Rules

Section 863(d)(2) provides that space or ocean activity means any activity conducted in space, and any activity conducted in or under water not within the jurisdiction of the United States or a foreign country. Proposed regulations §1.863–8(d)(1)(i) defines space as any area not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States, and not in international water.

Proposed regulations §1.863–8(d)(1)(i) provides that space activity is any activity

conducted in space, with certain exceptions. Space activity includes performance and provision of services in space, leasing of equipment or other property, including spacecraft (e.g., satellites) or transponders, located in space, licensing of technology or other intangibles for use in space, and the production, processing, or creation of property in space. Space activity includes the sale of property in space. Space activity also includes underwriting income from the insurance of risks on activities that produce income derived from space activity. The inclusion of such underwriting income is consistent with language in the Senate Report. See Senate Report at 357.

Proposed regulations §1.863-8(d)(1)(ii) provides that ocean activity is any activity conducted in international water, with certain exceptions. Ocean activity includes performance and provision of services in international water, leasing of equipment or other property located in international water, licensing of technology or other intangibles for use in international water, and the production, processing, or creation of property in international water. Ocean activity includes the sale of property in international water, and the sale of inventory under international water, but does not include the selling of inventory if the sale takes place on international water. Thus, if property sold on international water is inventory property, income attributable to sales activity is sourced under §1.861-7(c).

Ocean activity also includes underwriting income from the insurance of risks on activities that produce income derived from ocean activity. The inclusion of such underwriting income is consistent with language in the Senate Report. See Senate Report at 357.

Ocean activity also includes any activity performed in Antarctica. Ocean activity further includes the leasing of a vessel if such vessel does not transport cargo or persons for hire between ports-of-call. Thus, for example, income earned by a lessor of a vessel that is to engage only in research activities in international water is ocean income. Ocean activity also includes the leasing of drilling rigs, extraction of minerals, and performance and provision of services related thereto, to the extent the mines, oil and gas wells, or other natural deposits are not within the

jurisdiction of the United States, U.S. possessions, or any foreign country (as defined in section 638).

Based on legislative history, the IRS and Treasury believe space and ocean activity should be broadly defined based on legislative history. The legislative history clearly indicates that Congress intended to characterize certain land based activity as space or ocean activity. See Senate Report at 357. Consistent with that determination, the proposed regulations provide that when activities occur both in space or in international water and outside space and international water, and constitute parts of a single transaction described in §1.863-8(d)(1), the transaction will be characterized as space or ocean activity. Thus, for example, income from the lease of equipment located in space will be sourced in its entirety under section 863(d), even though certain functions associated with the transaction may be performed outside space and international water. The rules of this section for defining space or ocean activity by combining activities occurring both in space or in international water and outside space and international water simply reflect existing principles for characterizing a transaction, and are fully consistent with rules for characterizing income for purposes of other source rules. Taxpayers enjoy flexibility in structuring their transactions that will be characterized under existing principles. To ensure the statutory purpose is not circumvented, the Commissioner may treat parts of a transaction as separate transactions, or combine separate transactions as a single transaction.

Certain activities occurring in space or international water are not considered either space or ocean activity. Proposed regulations §1.863-8(d)(3)(i) provides that space or ocean activity does not include any activity giving rise to transportation income as defined in section 863(c). Proposed regulations §1.863-8(d)(3)(ii) provides that space or ocean activity also does not include any activity with respect to mines, oil and gas wells, or other natural deposits to the extent the mines or wells are located within the jurisdiction (as recognized by the United States) of any country, including the United States and its possessions (as defined in section 638). Proposed regulations §1.863-8(d)(3)(iii) provides that

space or ocean activity does not include any activity giving rise to international communications income as defined in proposed regulations §1.863-9(d)(3)(ii). These exceptions are consistent with section 863(d)(2)(B) of the Code.

b. Special Rules in Determining Space or Ocean Activity

Proposed regulations §1.863-8(d)(2)(ii)(A) provides that services are performed in space or in international water if functions are performed, resources employed, risks assumed, or other contributions to the value of the transaction occur in space or international water, whether such contributions are performed by personnel, or equipment, or otherwise. The IRS and Treasury believe that all contributions to a transaction's value, whether contributed by personnel, equipment, or otherwise, should be considered in determining whether services are performed in space or international water.

Proposed regulations §1.863-8(d)(2)(ii)(A) provides that the performance of a service is treated as a space or ocean activity if a part of the service is performed in space or international water. The IRS and Treasury recognize that this rule may be over-inclusive in certain cases. Therefore, proposed regulations §1.863-8(d)(2)(ii)(B) provides that the performance of a service will not be a space or ocean activity if the only activity of the taxpayer in space or in international water is to facilitate the taxpayer's own communications, as part of provision or delivery of a service by the taxpayer, and that service would not otherwise be in whole or in part a space or ocean activity. Several examples in the regulations illustrate this facilitation exception. The IRS and Treasury recognize that taxpayers may use communications services in conducting a business, and the fact that such communications may be routed through space or international water instead of by way of land should not produce differences in the source of the taxpayer's income derived from such service.

5. Treatment of partnerships

Proposed regulations §1.863-8(e) provides that for U.S. partnerships, section

863(d) and the regulations thereunder will be applied at the partnership level. The IRS and Treasury believe this rule is consistent with section 7701(a)(30)(B), which defines a U.S. person as a domestic partnership. For foreign partnerships, section 863(d) and the regulations thereunder will be applied at the partner level. The proposed regulations provide a different rule for foreign partnerships because IRS and Treasury are concerned that U.S. persons may use a foreign partnership to circumvent the purposes of this section. For example, two U.S. persons by the simple expediency of forming a foreign partnership can change significantly the U.S. tax consequences under section 863(d).

6. Reporting and documentation requirements

When a taxpayer allocates gross income to the satisfaction of the Commissioner under §1.863-8(b)(3) (income of certain foreign persons), §1.863-8(b)(4)(ii)(C) (certain production activity), or under §1.863-8(b)(5) (services) of the proposed regulations, the taxpayer must do so by making the allocation on a timely filed original return (including extensions). An amended return does not qualify, and section 9100 relief will not be available. In all cases, a taxpayer must maintain contemporaneous documentation regarding the allocation of gross income, and allocation of expenses, losses, and other deductions, the methodology used, and the circumstances justifying use of that methodology. The taxpayer must produce such documentation within 30 days upon request.

B. Communications Activity Under Sections 863(a), (d), and (e)

1. Scope

Section 1.863-9 of the proposed regulations provides rules for sourcing income derived from communications activity, notwithstanding any other section. Pursuant to proposed regulations §1.863-8, these source rules apply to communications activity that is also space or ocean activity.

2. Source of gross income derived from communications activity

a. International Communications Income

Section 863(e)(1)(A) states that any international communications income of a U.S. person will be sourced 50 percent to the United States and 50 percent to foreign sources. Proposed regulations §1.863-9(b)(2)(i) provides that international communications income of a U.S. person will be sourced 50 percent to the United States and 50 percent to foreign sources.

Section 863(e)(1)(B)(i) provides that any international communications income of a foreign person will be foreign source income except as provided in regulations or in section 863(e)(1)(B)(ii). Proposed regulations §1.863-9(b)(2)(ii)(A) states the general rule that international communications income of a foreign person is foreign source income. However, the proposed regulations contain several exceptions to the general rule.

Proposed regulations §1.863-9(b)(2)(ii)(B) states that if a foreign corporation is 50 percent or more owned by vote or value (directly, indirectly, or constructively) by U.S. persons, or is a controlled foreign corporation within the meaning of section 957, all international communications income is U.S. source income. This rule reflects IRS and Treasury's concern that U.S. persons may use a foreign corporation to obtain benefits that are inconsistent with the purposes of this section.

Section 863(e)(1)(B)(ii) provides that if a foreign person has a U.S. fixed place of business, international communications income attributable to the fixed place of business is U.S. source income. Consistent with section 863(e)(1)(B)(ii), proposed regulations §1.863-9(b)(2)(ii)(C) states that if a foreign person, other than a foreign person described in paragraph (b)(2)(ii)(A), maintains an office or other fixed place of business in the United States, any international communications income attributable to the office or other fixed place of business is U.S. source income. The principles of section 864(c)(5) will apply to determine whether

a foreign person has an office or fixed place of business in the United States. This rule does not apply if the foreign person is engaged in a U.S. trade or business.

Proposed regulations §1.863-9(b)(2)(ii)(D) provides that if a foreign person is engaged in a U.S. trade or business, the foreign person's international communications income is presumed to be U.S. source income. The rule reflects IRS and Treasury's concern that a foreign person could avoid a U.S. fixed place of business under section 863(e)(1)(B)(ii), yet engage in significant communications activity in the United States. The IRS and Treasury believe Congress intended that a foreign person engaged in substantial U.S. business in the United States be subject to U.S. tax on that communications activity.

The IRS and Treasury recognize that this rule may be over-inclusive in certain cases. Therefore, the proposed regulations provide that if the foreign person can allocate income to international communications activity outside the United States and space and international water, to the satisfaction of the Commissioner, based on the facts and circumstances, which may include functions performed, resources employed, risks assumed, or other contributions to value, then the income allocated to such communications activity outside the United States and space and international water will be foreign source income. When a foreign person is entitled to the benefits of a tax treaty with the United States, such person may elect to be taxed under the rules of that treaty, so that, for example, the United States would tax only income attributable to a permanent establishment of that foreign person, regardless of the amount of income considered effectively connected with a U.S. trade or business.

b. Other Communications Income

The proposed regulations also provide rules, for both U.S. and foreign persons, for determining the source of income from communications activity that does not qualify as international communications activity. The IRS and Treasury believe rules that address income from

other communications activities are necessary based on the legislative history. See Senate Report at 357.

Proposed regulations §1.863-9(b)(3) states that the source of income derived by either a U.S. or foreign person from U.S. communications activity is U.S. source income. Proposed regulations §1.863-9(b)(4) states that the source of income derived by either a U.S. or foreign person from foreign communications activity is foreign source income. Proposed regulations §1.863-9(b)(5) states that the source of income derived from space/ocean communications activity is determined under section 863(d) and the regulations thereunder.

3. Taxable income

When a taxpayer allocates gross income under paragraph (b)(2)(ii)(D) (certain foreign persons), or (d)(1)(ii) (determining a communications activity), the taxpayer must allocate or apportion expenses, losses, and other deductions as prescribed in §§1.861-8 through 1.861-14T of the regulations to the class of gross income, which must include the total income so allocated in each case. A taxpayer must then apply the rules of §§1.861-8 through 1.861-14T of the regulations to properly allocate or apportion amounts of expenses, losses, and other deductions allocated or apportioned to such gross income between gross income from sources within the United States and without the United States. For amounts of expenses, losses, and other deductions allocated or apportioned to gross income derived from international communications activity, when the source of income is determined under the 50/50 method of paragraph (b)(2)(i), taxpayers must apportion expenses and other deductions between U.S. and foreign sources pro rata based on the relative amounts of U.S. and foreign source gross income. Research and experimental expenditures qualifying under §1.861-17 are allocated under that section.

When a taxpayer must allocate gross income to the satisfaction of the Commissioner based on the facts and circumstances, IRS and Treasury believe that such allocations would be based generally on section 482 principles. However, IRS and Treasury solicit com-

ments on this approach, including specific comments and examples on alternative methods that could be used to make these allocations.

4. *Definition of communications activity and income derived from communications activity*

a. Communications Activity

Proposed regulations §1.863-9(d)(1) defines a communications activity as an activity consisting solely in the delivery by transmission of communications or data (communications). The definition of a communications activity is limited to the function of transmitting a particular communication from point A to point B. The delivery of communications by means other than transmission, for example, delivery of a letter is not a communications activity. The IRS and Treasury believe that this narrow definition of communications activity is consistent with the legislative history of section 863(e). See Senate Report at 357.

The provision of capacity to transmit communications or data is considered to be a communications activity. For example, the provision of satellite transponder capacity can qualify as a communications activity.

The provision of content or any other additional service will not be treated as a communications activity unless de minimis. For example, changes in the form of a voice communication when switching from analog technology to digital data for Internet telephony would be disregarded in determining whether there has been a transmission of communications within the meaning of proposed regulations §1.863-9(d). However, payment for information from a data base sent electronically, or for income attributable to an entertainment event transmitted electronically, would not be income derived from a communications activity.

When the provision of content or any other services is de minimis, such content or services are ignored, and the transaction will be treated solely as the transmission of communications within the meaning of proposed regulations §1.863-9(d)(1). The determination of whether the provision of content or other services is de minimis should be based on all the facts and circumstances. The IRS and Treasury

believe the exclusion of content and other services is consistent with the legislative history of section 863(e). No evidence exists in the Congressional testimony or in the legislative history that content provided by transmission was to be considered a communications activity.

Proposed regulations §1.863-9(d)(1)(ii) requires that a transaction encompassing non-de minimis communications activities and non-de minimis non-communications activities must be broken into parts and each part treated as a separate transaction. Proposed regulations §1.863-9(d)(1)(ii) states that gross income derived from the activities must be allocated to each separate transaction, to the satisfaction of the Commissioner, based on all relevant facts and circumstances, which may include functions performed, resources employed, risks assumed, and any other contributions to the value of the respective transactions. For example, a payment by an advertiser to a TV broadcast station may be in part a payment for transmission of the advertisement, but could also be a payment for other property or services, for example the transmitter's ability to reach a particular market or audience. Such activities, if not de minimis, must be treated as non-communications activities under §1.863-9(d)(1)(ii) of the proposed regulations.

To ensure the statutory purposes are not circumvented, the Commissioner may treat parts of a transaction as separate transactions, or construe separate transactions as a single transaction.

b. Income Derived from Communications Activity

Income derived from communications activity is defined in proposed regulations §1.863-9(d)(2) as income derived from the transmission of communications, including income derived from the provision of capacity to transmit communications. There is no requirement that the income recipient perform the transmission function. This rule reflects IRS and Treasury's understanding that those providing communications services often use capacity owned or operated by others. However, income is derived from communications activity only if the taxpayer is paid to transmit, and bears the risk of transmitting, the communications.

c. Character of Communications Activity

Proposed regulations §1.863-9(d)(3) provides rules for characterizing income derived from a communications activity for purposes of sourcing the income derived from such activity. The character of income derived from communications activity is determined by establishing the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication. Under the paid-to-do rule, the path the communication takes between the two points is not relevant in determining the character of the transmission. If a taxpayer is paid to take a communication from one point to another point, income derived from the transmission is characterized based on the transmission between those two points, even though the taxpayer contracts out part of the transmission to another. This rule reflects IRS and Treasury's recognition that those providing communications often use the network owned or operated by others. Several examples in the proposed regulations illustrate the paid-to-do rule.

Proposed regulations §1.863-9(d)(3)(ii) defines income derived from international communications activity as the transmission from a point in the United States and a point in a foreign country (or a possession of the United States). Proposed regulations §1.863-9(d)(3)(iii) defines income derived from U.S. communications activity as the transmission between two points in the United States or a point in the United States and a point in space or international water.

Proposed regulations §1.863-9(d)(3)(iv) defines income derived from foreign communications activity as the transmission between two points either in a foreign country or in foreign countries or a point in a foreign country and a point in space or international water. Proposed regulations §1.863-9(d)(3)(v) defines income derived from space/ocean communications activity as the transmission between a point in space or international water and another point in space or international water. The IRS and Treasury believe these rules are consistent with the legislative history. See Senate Report at 357.

When the taxpayer cannot establish the two points between which the taxpayer is paid to transmit, the source of income de-

rived from such activity, for either a U.S. or foreign person, is U.S. source income. Thus, for example, when a provider of communications services provides both local and international long distance along with cable services in one-price bundles for a set amount each month, tracing each transmission may not be possible or practical. In such cases, the source of income derived from communications activity is U.S. source income. The IRS and Treasury understand that many in the communications industry may not consider it practical or possible to prove the end points of the communications the taxpayer transmits. The IRS and Treasury solicit comments as to proposals for those situations when taxpayers cannot establish the points between which the taxpayer is paid to transmit the communications.

5. Treatment of partnerships

Proposed regulations §1.863-9(e) provides, in general, that for U.S. partnerships, section 863(e) and the regulations thereunder will be applied at the partnership level. The IRS and Treasury believe this rule is consistent with section 7701(a)(30)(B), which defines a U.S. person as a domestic partnership. For foreign partnerships, and in the case of a U.S. partnership in which 50 percent or more of the partnership interests are owned by foreign persons, section 863(e) and the regulations thereunder will be applied at the partner level. The proposed regulations provide a different rule for foreign partnerships and for U.S. partnerships with substantial foreign ownership because the IRS and Treasury are concerned that U.S. persons may use such partnerships to circumvent the purposes of this section.

6. Reporting rules and documentation requirements

When a taxpayer allocates gross income to the satisfaction of the Commissioner under proposed regulations §1.863-9(b)(2)(ii)(D) (certain foreign persons) or -(d)(1)(ii) (determining a communications activity), it does so by making the allocation on a timely filed original return (including extensions). An amended return does not qualify, and section 9100 relief will not be available. In all cases, a taxpayer must maintain con-

temporaneous documentation regarding the allocation of gross income, and allocation of expenses, losses and other deductions, the methodology used, and the circumstances justifying use of that methodology. The taxpayer must produce such documentation within 30 days upon request.

C. Amendment to the §1.863-3 Regulations

These proposed regulations amend the regulations under §1.863-3 for determining the source of income in certain inventory sales.

The regulations provide that in determining the source of income from sales of property when the property is either (i) produced in whole or in part in space or in international water, or (ii) sold in space or in international water, the rules of §1.863-8 of the proposed regulations apply. The rules of sections 863(a) and (b), and the regulations under those sections, do not apply to determine the source of income in such cases, except to the extent provided in §1.863-8 of the proposed regulations. The proposed regulations in §1.863-8(b)(4)(ii)(A) provide, however, that the source of income from sales of inventory on international water continues to be sourced under §1.863-3(c)(2). The regulations in §1.863-3(a)(1) and -3(c)(1)(i)(A) are amended to reflect these provisions.

The proposed regulations also amend §1.863-3(c)(2) to provide that the place of sale will be presumed to be the United States, for purposes of that section, when property is produced in the United States and the property is sold to a U.S. resident for use, consumption, or disposition in space. See §1.864-6(b)(3) for determining whether property is used in space and whether the sale is to a U.S. resident.

These rules reflect the views of Treasury and the IRS that sales of satellites or transponders by a U.S. resident in space should produce U.S. source income. These rules also reflect the view that sales of such property by a U.S. resident to a U.S. purchaser should produce U.S. source income. Treasury and the IRS believe that these provisions are consistent with Congress' intent in enacting section 863(d) to tax U.S. persons on a residency basis on income that is not likely to be subject to foreign tax

by a foreign country. It is also consistent with the tax policy of the foreign tax credit that income not likely to be subject to foreign tax should not be treated as foreign source income, which would inappropriately allow taxpayers with excess foreign tax credits to shelter this income from U.S. tax.

Proposed Effective Dates

These regulations are proposed to apply for taxable years beginning on or after the date that is 30 days after the date of publication of final regulations in the Federal Register.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the rules of this section principally impact large multinationals who pay foreign taxes on substantial foreign operations and therefore the rules will impact very few small entities. Moreover, in those few instances where the rules of this section impact small entities, the economic impact on such entities is not likely to be significant. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely (in the manner described under the ADDRESSES caption) to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for March 28, 2001, at 10 a.m., in the

auditorium, seventh floor, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit comments and an outline of topics to be discussed and the time to be devoted to each topic (in the manner described under the ADDRESSES caption of this preamble) by March 7, 2001.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Anne Shelburne, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.863–8 also issued under 26 U.S.C. 863(a), (b) and (d).

Section 1.863–9 also issued under 26 U.S.C. 863(a), (d) and (e). * * *

Par. 2 Section 1.863–3 is amended by:

1. Adding a sentence after the first sentence in paragraph (a)(1).

2. Adding a sentence at the end of paragraph (c)(1)(i)(A).

3. Adding three sentences, one after the current first sentence of paragraph (c)(2), and the other two sentences after the current second sentence of paragraph (c)(2).

The additions read as follows:

§1.863–3 Allocation and apportionment of income from certain sales of inventory.

(a) * * * (1) * * * To determine the source of income from sales of property produced by the taxpayer, when the property is either produced in whole or in part in space or on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States (in international water), or is sold in space or in international water, the rules of §1.863–8 apply, and the rules of this section do not apply, except to the extent provided in §1.863–8. * * *

(c) * * * (1) * * * (i) * * * (A) * * * For rules regarding the source of income when production takes place, in whole or in part, in space or in international water, the rules of §1.863–8 apply, and the rules of this section do not apply except to the extent provided in §1.863–8. * * *

(c)(2) * * * Notwithstanding any other provision, for rules regarding the source of income when a sale takes place in space or in international water, the rules of §1.863–8 apply, and the rules of this section do not apply except to the extent provided in §1.863–8. * * * The place of sale will be presumed to be the United States under this rule when property is produced in the United States and the property is sold to a U.S. resident, who uses the property in space or in international water. In such cases, the property will be treated as sold for use, consumption, or disposition in the United States. * * *

Par. 3 Section 1.863–8 and 1.863–9 are added to read as follows:

§1.863–8 Source of income from space and ocean activity under section 863(d).

(a) *In general.* Income of a U.S. or a foreign person derived from space or

ocean activity (space or ocean income) is sourced under the rules of this section, notwithstanding any other provision, including sections 861, 862, 863, and 865. A taxpayer will not be considered to derive income from space or ocean activity, as defined in paragraph (d) of this section, if such activity is performed by another person, subject to the rules for the treatment of consolidated groups in section §1.1502-13.

(b) *Source of gross income from space or ocean activity*—(1) *In general.* Income derived by a U.S. person from space or ocean activity is income from sources within the United States, except as otherwise provided in this paragraph (b). Income derived by a person other than a United States person from space or ocean activity is income from sources without the United States, except as otherwise provided in this paragraph (b).

(2) *Income derived by certain foreign corporations.* If a U.S. person or U.S. persons own 50 percent or more of the vote or value of the stock of a foreign corporation (directly, indirectly or constructively) that is not a controlled foreign corporation within the meaning of section 957, all income derived by that foreign corporation from space or ocean activity is U.S. source income.

(3) *Income derived by foreign persons engaged in a U.S. trade or business.* If a foreign person, other than a controlled foreign corporation within the meaning of section 957 or a foreign person described in paragraph (b)(2) of this section, is engaged in a U.S. trade or business, all income derived by that person from space or ocean activity is presumed to be U.S. source income. However, if the foreign person can allocate income between sources within the United States, or space, or international water, and sources outside the United States and space and international water, to the satisfaction of the Commissioner, based on the facts and circumstances, which may include functions performed, resources employed, risks assumed, or other contributions to value, then space or ocean income allocated to sources outside the United States and space and international water shall be treated as from sources outside the United States.

(4) *Source rules for income from certain sales of property*—(i) *Sales of pur-*

chased property. When a taxpayer sells property in space or in international water, the source of gross income shall be determined under paragraph (b)(1), (2), or (3) of this section as applicable. However, if inventory, within the meaning of section 1221(1), is sold on international water, the source of income shall be determined under §1.863-3(c)(2).

(ii) *Sales of property produced by the taxpayer*—(A) *General.* If the taxpayer both produces property and also sells such property, the taxpayer must divide gross income from such sales between production activity and sales activity under the 50/50 method as described in this paragraph (b)(4)(ii)(A). Under the 50/50 method, one-half of the taxpayer's gross income will be considered income attributable to production activity, and the source of that income will be determined under paragraphs (b)(4)(ii)(B) or (C) of this section. The remaining one-half of such gross income will be considered income attributable to sales activity and the source of that income will be determined under paragraph (b)(4)(i) of this section. However, if the taxpayer sells such property outside space and outside international water, the source of gross income attributable to sales activity will be determined under §1.863-3(c)(2).

(B) *Production only in space or in international water, or only outside space and international water.* When production occurs only in space or in international water, income attributable to production activity is sourced under paragraph (b)(1), (2), or (3) of this section as space or ocean income. When production occurs only outside space and international water, income attributable to production activity is sourced under §1.863-3(c)(1).

(C) *Production both in space or in international water and outside space and international water.* When property is produced in space or in international water and outside space and international water, gross income must be allocated to production occurring in space or in international water and production occurring outside space and international water, to the satisfaction of the Commissioner, based on all the facts and circumstances, which may include functions performed, resources employed, risks assumed, and any other contributions to value. The

source of gross income allocated to space or international water is determined under paragraph (b)(1), (2), or (3) of this section. The source of gross income allocated outside space and international water is determined under §1.863-3(c)(1).

(5) *Special rule for determining the source of gross income from services.* If a transaction characterized as the performance of services constitutes a space or ocean activity by reason of the performance of part of the service in space or in international water, as determined under paragraph (d)(2)(ii)(A) of this section, the source of all gross income derived from such transaction of which such performance is a part is determined under paragraph (b)(1), (2), or (3) of this section. However, if the taxpayer can allocate gross income between performance occurring outside space and international water, and performance occurring in space or international water, to the satisfaction of the Commissioner, based on the facts and circumstances, including functions performed, resources employed, risks assumed, or other contributions to value, then the source of income allocated to performance occurring outside space and international water shall be determined under sections 861, 862, 863, and 865.

(6) *Special rule for determining source of income from communications activity (other than income from international communications activity).* Space and ocean activity, as defined in paragraphs (d)(1) and (2) of this section, includes activity occurring in space or in international water that is characterized as a communications activity as defined in §1.863-9(d). The source of gross income from space or ocean activity that is also a communications activity as defined in §1.863-9(d) is determined under the rules of §1.863-9(b), rather than under paragraph (b) of this section.

(c) *Taxable income.* When a taxpayer allocates gross income under paragraph (b)(3), (b)(4)(ii)(C), or (b)(5) of this section, to the satisfaction of the Commissioner, based on all the facts and circumstances, the taxpayer must allocate or apportion expenses, losses, and other deductions as prescribed in §§1.861-8 through 1.861-14T to the class of gross income, which must include the total income so allocated in each case. A tax-

payer must then apply the rules of §§1.861–8 through 1.861–14T to properly allocate or apportion amounts of expenses, losses, and other deductions allocated or apportioned to such gross income between gross income from sources within the United States and without the United States.

(d) *Space and Ocean activity*—(1) *Definition*—(i) *Space activity*. In general, space activity is any activity conducted in space. Space activity includes performance and provision of services in space, as defined in paragraph (d)(2)(ii)(A) of this section, leasing of equipment located in space, including spacecraft (e.g., satellites) or transponders located in space, licensing of technology or other intangibles for use in space, and the production, processing, or creation of property in space, as defined in paragraph (d)(2)(i) of this section. Space activity includes activity occurring in space that is characterized as communications activity (other than international communications activity) under §1.863–9(d). Space activity also includes underwriting income from the insurance of risks on activities that produce space income. Space activity includes the sale in space of property, as defined in paragraph (d)(2)(iii) of this section. For purposes of this section, space means any area not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States, and not in international water. For purposes of determining space activity, the Commissioner may separate parts of a single transaction into separate transactions or combine separate transactions as parts of a single transaction. Paragraph (d)(3) of this section lists exceptions to the general rule.

(ii) *Ocean activity*. In general, ocean activity is any activity conducted on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States (collectively, in international water). Ocean activity includes performance and provision of services in international water, as defined in paragraph (d)(2)(ii)(A) of this section, leasing of equipment located in international water, including underwater cables, licensing of technology or other intangibles for use in international water, and the

production, processing, or creation of property in international water, as defined in paragraph (d)(2)(i) of this section. Ocean activity includes sales of property in international water, as defined in paragraph (d)(2)(iii) of this section, but ocean activity does not include the selling of inventory as defined in section 1221(1) on international water. Ocean activity includes activity occurring in international water that is characterized as communications activity (other than international communications activity) under §1.863–9(d). Ocean activity also includes underwriting income from the insurance of risks on activities that produce ocean income. Ocean activity also includes any activity performed in Antarctica. Ocean activity further includes the leasing of a vessel if such vessel does not transport cargo or persons for hire between ports-of-call. Thus, for example, the leasing of a vessel that is to engage only in research activities in international water is an ocean activity. Except as provided in paragraph (d)(3)(ii) of this section, ocean activity also includes the leasing of drilling rigs, extraction of minerals, and performance and provision of services related thereto. For purposes of determining ocean activity, the Commissioner may separate parts of a single transaction into separate transactions or combine separate transactions as parts of a single transaction. Paragraph (d)(3) of this section lists exceptions to the general rule.

(2) *Determining a space or ocean activity*—(i) *Production of property in space or in international water*. For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages property within the meaning of sections 864(a) and §1.864–1.

(ii) *Special rule for performance of services*—(A) *General*. If a transaction is characterized as the performance of a service, then such service will be treated as a space or ocean activity when a part of the service, even if de minimis, is performed in space or in international water. Services are performed in space or in international water if functions are performed, resources employed, risks assumed, or other contributions to value occur in space or in international water, regardless of whether performed by personnel, or equipment, or otherwise.

(B) *Exception to the general rule—facilitating the taxpayer's own communications*. If a taxpayer's only activity in space or in international water is to facilitate the taxpayer's own communications as part of the provision or delivery of a service provided by the taxpayer, and that service would not otherwise be in whole or in part a space or ocean activity, such service will not be treated as either space or ocean activity because of such facilitation.

(iii) *Sale in space or in international water*. In applying §1.861–7(c) to determine where a sale takes place, property will be sold in space or in international water if the property is located in space or in international water when rights, title and interest pass to the buyer (or when bare legal title is retained, at the time and place of passage of beneficial ownership and risk of loss), or if property is sold for use in space or in international water.

(3) *Exceptions to space or ocean activity*. Space or ocean activity does not include the following types of activities—

(i) Any activity giving rise to transportation income as defined in section 863(c); or

(ii) Any activity with respect to mines, oil and gas wells, or other natural deposits to the extent the mines or wells are located within the jurisdiction (as recognized by the United States) of any country, including the United States and its possessions; or

(iii) Any activity giving rise to international communications income as defined in §1.863–9(d)(3)(ii).

(e) *Treatment of partnerships*. In the case of a U.S. partnership, this section will be applied at the partnership level. In the case of a foreign partnership, this section will be applied at the partner level.

(f) *Examples*. The following examples illustrate the rules of this section:

Example 1. Space activity—activity occurring on land and in space. (i) *Facts*. S owns satellites, and leases one of its satellites to A. S, as lessor, will not operate the satellite. Part of S's performance as lessor in this transaction occurs on land.

(ii) *Analysis*. The combination of S's activities is characterized as the lease of equipment. Since the equipment is located in space, the transaction is defined as space activity under paragraph (d)(1)(i) of this section. Income derived from the lease will be sourced in its entirety under paragraph (b) of this section.

Example 2. Space activity. (i) *Facts*. X is an Internet service provider, offering a service to per-

sonal computer users accessing the Internet. This service permits a customer, C, to make a call, initiated by a modem, routed to a control center, for connection to the World Wide Web. X transmits the requested information over its satellite capacity leased from S to C's personal computer. X charges its customers a flat monthly fee. Assume neither X nor S derive international communications income within the meaning of §1.863-9(d)(3)(ii).

(ii) *Analysis.* In this case, X performs a service, and X's activity in space is not simply facilitation within the meaning of paragraph (d)(2)(ii)(B) of this section, because X's activity is not simply the facilitation of X's own communications and because X's activity is not just part of another service provided by X. Thus, X's activity constitutes space activity in its entirety under paragraph (d)(2)(ii)(A) of this section, and the source of X's income is determined under paragraph (b) of this section. To the extent X derives income from communications activity, within the meaning of §1.863-9(d), the source of X's income is determined under §1.863-9(b), as provided in paragraph (b)(6) of this section. S derives communications income within the meaning of §1.863-9(d), and therefore the source of S's income is determined under §1.863-9(b), as provided in paragraph (b)(6) of this section.

Example 3. Services as space activity-facilitation of communications. (i) *Facts.* R owns a retail outlet in the United States. R employs S to provide a security system for R's premises. S operates its security system by transmitting images from R's premises to a satellite, and from there to a group of S employees located in Country B, who then monitor the premises by viewing the transmitted images. O provides S with transponder capacity on O's satellite, which S uses to transmit those images.

(ii) *Analysis.* S derives income for providing monitoring services. Because, in this case, S uses O's satellite transponder to transmit images to facilitate S's own communications in space as part of its provision of a security service, S's activity in space is limited to facilitating communications as described in paragraph (d)(2)(ii)(B) of this section. Thus, S is not engaged in a space activity, and none of S's income is space income. Assuming O's provision of capacity is viewed as the provision of a service, O's activity in space is not simply the facilitation of communications as provided in paragraph (d)(2)(ii)(B) of this section, because O is not just facilitating its own communications. Thus, O's activity is characterized as space activity in its entirety under paragraph (d)(2)(ii)(A) of this section (unless O's activity in space qualifies as international communications activity). To the extent O derives income from communications activity, within the meaning of §1.863-9(d), the source of O's income is determined under §1.863-9(b), as provided in paragraph (b)(6) of this section. On these facts, R does not derive any income from space activity.

Example 4. Space activity. (i) *Facts.* L, a U.S. company, offers programming and also certain services to customers located both in the United States and in foreign countries. Assume L's provision of programming and services in this case was viewed as the provision of a service, with no part of that service occurring in space. L uses satellite capacity acquired from S to deliver the service directly to customers' television sets, so that the delivery of the service occurs in space. Assume the delivery in this

case is not considered de minimis. L also acquires programming from H, and L pays H a royalty for use of copyrighted material in the United States and in foreign countries. Customer, C, pays L for delivery of the service to C's residence in the United States. Assume S's provision of capacity in this case was viewed as the provision of a service, and also that S does not derive international communications income within the meaning of §1.863-9(d)(3)(ii).

(ii) *Analysis.* On these facts, S's activity in space is not just the facilitation of its own communications within the meaning of paragraph (d)(2)(ii)(B) of this section, because S is facilitating the communications of others. To the extent S derives income from a space activity that is also a communications activity under §1.863-9(d), the source of S's income is determined under §1.863-9(b), as provided in paragraph (b)(6) of this section. On these facts, L is treated as providing a service and is paid to deliver that service to its customers, and each transaction, i.e., the provision of the service and the delivery of the service, constitutes a separate transaction. L's income derived from provision of the service is not income derived from space activity. L's income derived from delivery of the service is space activity. L's delivery of the service is not just the facilitation of L's own communications within the meaning of paragraph (d)(2)(ii)(B) of this section, because it is not just a part of the provision of a service, but instead the entire service. Since L derives communications income within the meaning of §1.863-9(d), the source of L's income is determined under §1.863-9(b), as provided in paragraph (b)(6) of this section. If on other facts, L provides a service and delivers that service, and L treats the provision of the service and the delivery of the service as one separate transaction, then L performs services in space under paragraph (d)(2)(ii)(A) of this section, because the delivery of the service occurs in space. However, L's activity in space would be limited to facilitating its own communications within the meaning of paragraph (d)(2)(ii)(B) of this section, because it is part of another service that would not otherwise be a space activity. As a result, L's provision of the service would not be a space activity under paragraph (d)(2)(ii)(A) of this section.

Example 5. Space activity—treatment of land activity. (i) *Facts.* S, a U.S. person, offers remote imaging products and services to its customers. In year 1, S uses its satellite's remote sensors to gather data on certain geographical terrain. In year 3, C, a construction development company, contracts with S to obtain a satellite image of an area for site development work. S pulls data from its archives and transfers to C the images gathered in year 1, in a transaction that is characterized as a sale of the data. Title to the data passes to C in the United States. Before transferring the images to C, S uses computer software to enhance the images so that the images can be used.

(ii) *Analysis.* The collection of data and creation of images in space is characterized as the creation of property in space. S's income is derived from production of property in part in space, and is, therefore, derived in part from space activity. The source of S's income from production and sale of property is, therefore, determined under paragraph (b)(4) of this section. Since production activity occurs both in space and on land, the source of S's production income is determined under paragraphs (b)(4)(ii)(A)

and (C) of this section. The source of S's income attributable to sales activity is determined under paragraph (b)(4)(ii)(A) of this section and §1.863-3(c)(2) as U.S. source income.

Example 6. Use of intangible property in space. (i) *Facts.* X acquires a license to use a particular satellite slot or orbit, which X sublicenses to C. C pays X a royalty.

(ii) *Analysis.* Since the royalty is paid for the right to use intangible property in space, the source of X's royalty is determined under paragraph (b) of this section.

Example 7. Performance of services. (i) *Facts.* E, a U.S. company, operates satellites with sensing equipment that can determine how much heat and light particular plants emit and reflect. Based on the data, E will provide F, a U.S. farmer, a report analyzing the data, which F will use in growing crops. E analyzes the data from U.S. offices.

(ii) *Analysis.* Assume E's combined activities are characterized as the performance of services. Because part of the service is performed in space, all income E derives from the transaction will be treated as derived from space activity under paragraph (d)(2)(ii)(A) of this section. The source of such income will be determined under paragraph (b)(5) of this section. If, however, E can allocate gross income, to the satisfaction of the Commissioner, as prescribed in paragraph (b)(5) of this section, then the source of gross income attributable to services performed outside space may be determined as provided in paragraph (b)(5) of this section.

Example 8. Separate transactions. (i) *Facts.* The same facts as *Example 7*, except that E provides the raw data to F in a transaction characterized as a sale of a copyrighted article, and in addition also provides an analysis in the form of a report to F, a U.S. farmer who uses the information in growing crops. The price F pays E for the raw data is separately stated.

(ii) *Analysis.* To the extent the provision of raw data and the analysis of the data are each treated as separate transactions, the source of income from the production and sale of data is determined under paragraph (b)(4) of this section. The provision of services would be analyzed in the same manner as in *Example 7*.

Example 9. Sale of property under international water. (i) *Facts.* T owns transatlantic cable lying under the ocean, which it purchased. T sells the cable to B.

(ii) *Analysis.* Because the property is sold under international water as provided in paragraph (d)(2)(iii) of this section, the transaction is ocean activity under paragraph (d)(1)(ii) of this section, and the source of income is determined under paragraph (b)(4)(i) of this section, by reference to paragraph (b)(1), (2), or (3) of this section.

Example 10. Sales of property in space. (i) *Facts.* S manufactures a satellite in the United States and sells it to a U.S. customer, with the rights, title, and interest passing to the customer when the satellite is located in space.

(ii) *Analysis.* The source of income derived from the sale of the satellite in space is determined under paragraph (b)(4) of this section, with the source of income attributable to production activity determined under paragraphs (b)(4)(ii)(A) and (B) of this section, and the source of income attributable to sales activity determined under paragraphs

(b)(4)(ii)(A) and (b)(4)(i) of this section, by reference to paragraph (b)(1), (2), or (3) of this section.

Example 11. Sale of property located in space.

(i) *Facts.* S has a right to operate from a particular position in space. S sells the right to operate from that satellite slot or orbit to P.

(ii) *Analysis.* Because the sale takes place in space, as provided in paragraph (d)(2)(iii) of this section, gain on the sale of the satellite slot or orbit is income derived from space activity under paragraph (d)(1)(i) of this section, and income from the sale is sourced under paragraph (b)(4)(i) of this section, by reference to paragraph (b)(1), (2), or (3) of this section.

Example 12. Source of income of a foreign person. (i) *Facts.* FP, a foreign company, not a controlled foreign corporation within the meaning of section 957, derives income from the operation of satellites. FP operates a ground station in the United States and in foreign country, FC.

(ii) *Analysis.* In this case, FP is engaged in a U.S. trade or business of operating the ground station. Thus, under paragraph (b)(3) of this section, all FP's income derived from space activity is presumed to be U.S. source income. However, if FP can allocate space income to contributions occurring outside the United States, space, and international water, as provided in paragraph (b)(3) of this section, for example, to the ground station located in FC, then such space income so allocated will be from sources outside the United States.

Example 13. Source of income of a foreign person. (i) *Facts.* FP, a foreign company, not a controlled foreign corporation within the meaning of Section 957, operates remote sensing satellites, collecting data and images in space for its customers. FP uses an independent agent, A, in the United States who provides marketing, order taking, and other customer service functions.

(ii) *Analysis.* In this case, FP is engaged in a U.S. trade or business on the basis of A's activities on its behalf in the United States. Therefore, under paragraph (b)(3) of this section, all of FP's income derived from space activity is presumed to be space income. However, if FP can allocate income to contributions occurring outside the United States, space, and international water, as provided in paragraph (b)(3) of this section, then such income so allocated will be from sources outside the United States.

(g) *Reporting and documentation requirements.* When a taxpayer allocates gross income, to the satisfaction of the Commissioner, under paragraph (b)(3), (b)(4)(ii)(C), or (b)(5) of this section, it does so by making the allocation on a timely filed original return (including extensions). An amended return does not qualify for this purpose, nor shall the provisions of §301.9100-1 of this chapter and any guidance promulgated thereunder apply. In all cases, a taxpayer must maintain contemporaneous documentation in existence when such return is filed re-

garding the allocation of gross income and allocation or apportionment of expenses, losses and other deductions, the methodology used, and the circumstances justifying use of that methodology. The taxpayer must produce such documentation within 30 days upon request.

(h) *Effective date.* This section applies to taxable years beginning on or after the date that is 30 days after the date of publication of final regulations in the Federal Register.

§1.863-9 Source of income derived from communications activity under sections 863(a), (d), and (e).

(a) *In general.* Income of a U.S. or foreign person derived from communications activity is sourced under the rules of this section, notwithstanding any other provision including sections 861, 862, 863, and 865.

(b) *Source of gross income derived from communications activity—*(1) *In general.* The source of gross income derived from each type of communications activity, as defined in paragraph (d)(3) of this section, is determined under this paragraph (b). If a communications activity would qualify as space or ocean activity under section 863(d) and the regulations thereunder, the source of income derived from such communications activity is determined under this section, and not under section 863(d) and the regulations thereunder. See §1.863-8(b)(6).

(2) *Source of international communications income—*(i) *Income derived by a U.S. person.* Under the 50/50 method of this paragraph (b)(2)(i), income derived by a U.S. person from international communications activity is one-half from sources within the United States and one-half from sources without the United States.

(ii) *Income derived by foreign persons—*(A) *General rule.* Income derived by a person other than a U.S. person from international communications activity is, except as otherwise provided in this paragraph (b), wholly from sources without the United States.

(B) *Income derived by certain foreign corporations.* If a foreign corporation, in-

cluding a controlled foreign corporation within the meaning of section 957, is 50 percent or more owned by vote or value (directly, indirectly, or constructively) by U.S. persons, all income derived by that corporation from international communications activity is from sources within the United States.

(C) *Income derived by foreign persons with a U.S. fixed place of business.* If a foreign person (other than a foreign person described in paragraph (b)(2)(ii)(B) of this section) maintains an office or other fixed place of business in the United States, the foreign person's international communications income, as determined to the satisfaction of the Commissioner, attributable to the office or other fixed place of business is from sources within the United States. The principles of section 864(c)(5) apply in determining whether a foreign person has an office or fixed place of business in the United States. See §1.864-6 and -7. This paragraph does not apply if the foreign person is engaged in a U.S. trade or business.

(D) *Income derived by foreign persons engaged in a U.S. trade or business.* If a foreign person (other than a foreign person described in paragraph (b)(2)(ii)(B) of this section) is engaged in a U.S. trade or business, all of the foreign person's international communications income is presumed to be from sources within the United States. However, if the foreign person can allocate income between sources within the United States, or space, or international water and sources outside the United States and space and international water, to the satisfaction of the Commissioner, based on the facts and circumstances, which may include functions performed, resources employed, risks assumed, or other contributions to value, then the income allocated to sources outside the United States and space and international water shall be treated as from sources without the United States.

(3) *Source of U.S. communications income.* The source of income derived by a U.S. or a foreign person from U.S. communications activity is from sources within the United States.

(4) *Source of foreign communications income.* The source of income derived by

a U.S. or a foreign person from foreign communications activity is from sources without the United States.

(5) *Source of space/ocean communications income.* The source of income derived by a U.S. or a foreign person from space/ocean communications activity is determined under section 863(d) and the regulations thereunder, without regard to §1.863-8(b)(6).

(6) *Source of communications income when taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication.* The income derived by a U.S. person or foreign person from communications activity, when the taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication as required in paragraph (d)(3)(i) of this section, is from sources within the United States.

(c) *Taxable income.* When a taxpayer allocates gross income under paragraph (b)(2)(ii)(D) or (d)(1)(ii) of this section, to the satisfaction of the Commissioner, based on all the facts and circumstances, the taxpayer must allocate or apportion expenses, losses, and other deductions as prescribed in §§1.861-8 through 1.861-14T to the class of gross income, which must include the total income so allocated in each case. A taxpayer must then apply the rules of §§1.861-8 through 1.861-14T to properly allocate or apportion amounts of expenses, losses, and other deductions allocated or apportioned to such gross income between gross income from sources within the United States and without the United States. For amounts of expenses, losses, and other deductions allocated or apportioned to gross income derived from international communications activity, when the source of income is determined under the 50/50 method of paragraph (b)(2)(i) of this section, taxpayers must apportion expenses, losses, and other deductions between sources within and sources without pro rata based on the relative amounts of gross income from sources within the United States and without the United States. Research and experimental expenditures qualifying under §1.861-17 are allocated under that section, and are not allocated and apportioned pro rata under the method of paragraph (b)(2)(i) of this section.

(d) *Communications activity and income derived from communications activity—*

(i) *General rule.* For purposes of this part, communications activity consists solely of the delivery by transmission of communications or data (communications). Delivery of communications other than by transmission, for example, by delivery of physical packages and letters, is not communications activity within the meaning of this section. Communications activity also includes the provision of capacity to transmit communications. Provision of content or any other additional service provided along with, or in connection with, a non-de minimis communications activity must be treated as a separate non-communications activity unless *de minimis*.

(ii) *Separate transaction.* To the extent a taxpayer's transaction consists in part of non-de minimis communications activity and in part of non-de minimis non-communications activity, such parts of the transaction must be treated as separate transactions. Gross income must be allocated to each such transaction involving the communications activity and the non-communications activity to the satisfaction of the Commissioner, based on all relevant facts and circumstances, which may include functions performed, resources employed, risks assumed, and any other contributions to the value of the respective transactions. For purposes of determining whether income is derived from communications activity, the Commissioner may treat communications activity and non-communications activity, treated as a single transaction, as separate transactions, or combine separate communications activity transactions into a single transaction.

(2) *Income derived from communications activity.* Income derived from communications activity (communications income) is income derived from the delivery by transmission of communications, including income derived from the provision of capacity to transmit communications. Income may be considered derived from a communications activity even if the taxpayer itself does not perform the transmission function, but in all cases, the taxpayer derives communications income only if the taxpayer is paid to transmit,

and bears the risk of transmitting, the communications.

(3) *Determining the type of communications activity—*

(i) *In general.* Whether income is derived from international communications activity, U.S. communications activity, foreign communications activity, or space/ocean communications activity is determined by identifying the two points between which the taxpayer is paid to transmit the communication. The taxpayer must establish to the satisfaction of the Commissioner the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication. Whether the taxpayer contracts out part or all of the transmission function is not relevant.

(ii) *Income derived from international communications activity.* Income derived by a taxpayer from international communications activity (international communications income) is income derived from communications activity, as defined in paragraph (d)(1) of this section, when the taxpayer is paid to transmit between a point in the United States and a point in a foreign country (or a possession of the United States).

(iii) *Income derived from U.S. communications activity.* Income derived by a taxpayer from U.S. communications activity (U.S. communications income) is income derived from communications activity, as defined in paragraph (d)(1) of this section, when the taxpayer is paid to transmit—

(A) Between two points in the United States; or

(B) Between the United States and a point in space or in international water.

(iv) *Income derived from foreign communications activity.* Income derived by a taxpayer from foreign communications activity (foreign communications income) is income derived from communications activity, as defined in paragraph (d)(1) of this section, when the taxpayer is paid to transmit—

(A) Between two points in a foreign country or countries (or possession or possessions of the United States); or

(B) Between a foreign country (or a possession of the United States) and a point in space or in international water.

(v) *Income derived from space/ocean communications activity.* Income derived by a taxpayer from space/ocean commu-

nications activity (space/ocean communications income) is income derived from a communications activity, as defined in paragraph (d)(1) of this section, when the taxpayer is paid to transmit between a point in space or in international water and another point in space or in international water.

(e) *Treatment of partnerships*—(1) *General*. In the case of a U.S. partnership, this section will be applied at the partnership level. In the case of a foreign partnership, this section will be applied at the partner level.

(2) *Exception*. In the case of a U.S. partnership in which 50 percent or more of the partnership interests are owned by foreign persons, this section will be applied at the partner level.

(f) *Examples*. The following examples illustrate the rules of this section:

Example 1. Income derived from communications activity. (i) *Facts*. D provides its customers in various foreign countries with access to its data base. A customer, C, places a toll call to D's telephone number, and can then access D's data base to obtain certain information, such as C's customers' health care coverage.

(ii) *Analysis*. D is not paid to transmit communications and does not derive income solely from transmission of communications within the meaning of paragraph (d) of this section. D instead derives income from provision of content or provision of services to its customers.

Example 2. Income derived from U.S. communications activity. (i) *Facts*. Local telephone company (TC) receives access fees from an international carrier for picking up calls from a local telephone customer and delivering the call to a U.S. point of presence (POP) of the international carrier. The international carrier picks up the call from its U.S. POP and delivers the call to a foreign country.

(ii) *Analysis*. TC is not paid to carry the transmission between the United States and a foreign country. It is paid to transmit communications between two points in the United States. TC derives income from U.S. communications activity as defined in paragraph (d)(3)(iii) of this section, which is sourced under paragraph (b)(3) of this section as U.S. source income.

Example 3. Income derived from international communications activity. (i) *Facts*. TC, a U.S. company, owns an underwater fiber optic cable. Pursuant to three year contracts, TC makes capacity to transmit communications via the cable available to its customers. Such customers then solicit telephone customers and arrange for transmitting their calls. The cable runs in part through U.S. waters, through international waters, and in part through foreign country waters.

(ii) *Analysis*. TC derives income from communications activity under paragraph (d)(2) of this section. The income is derived from international communications activity as provided in paragraph (d)(3)(ii) of this section, since TC is paid to make available capacity to transmit between the United

States and a foreign country, and vice versa. Since TC is a U.S. person, TC's international communications income is sourced under paragraph (b)(2)(i) of this section as one-half from sources within the United States and one-half from sources without the United States.

Example 4. Character of communications activity: the paid-to-do rule. (i) *Facts*. TC is paid to transmit communications from Toronto, Canada, to Paris, France. TC transmits the communication to New York. TC pays another communications company, IC, to transmit the communications from New York to Paris.

(ii) *Analysis*. Under the paid-to-do rule of paragraph (d)(3)(i) of this section, TC derives income from foreign communications activity under paragraph (d)(3)(iv) of this section, since it is paid to transmit communications between two foreign points, Toronto and Paris. Under paragraph (d)(3)(i) of this section, the character of TC's activity is determined without regard to the fact that TC pays IC to transmit the communication for some portion of the delivery path. IC has international communications income under paragraph (d)(3)(ii) of this section, because it is paid to transmit the communication between a point in the United States and a point in a foreign country.

Example 5. Income derived from international communications activity. (i) *Facts*. S, a U.S. satellite operator, owns satellites and the uplink facilities in Country X, a foreign country. B, a resident of Country X, pays S to deliver its programming from Country X to its downlink facility in the United States, owned by C, a customer of B.

(ii) *Analysis*. S derives communications income under paragraph (d) of this section. S's income is characterized as international communications income under paragraph (d)(3)(ii) of this section, because S is paid to transmit the communication between the beginning point in a foreign country to an end point in the United States. The source of S's international communications income is determined under paragraph (b)(2)(i) of this section as one-half from sources within the United States and one-half from sources without the United States.

Example 6. Character of income derived from communications activity: the paid-to-do rule. (i) *Facts*. TC is paid to take a call from North Carolina to Iowa, two points in the United States, but routes the call through Canada.

(ii) *Analysis*. Under paragraph (d)(3)(i) of this section, the character of the income derived from communications activity is determined by the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communications, without regard to the path of the transmission between those two points. Thus, under paragraph (d)(3)(iii) of this section, TC derives income from U.S. communications activity because it is paid to transmit between two U.S. points.

Example 7. Source of income derived from communications activity. (i) *Facts*. A, a U.S. company, is an Internet access provider. A charges C a lump sum, paid monthly, for Internet access. A transmits a call made by C in France to a recipient in England, over the public Internet. A does not maintain records as to the beginning and end points of the transmission.

(ii) *Analysis*. Although A derives income from communications activity as defined in paragraph

(d)(1) of this section, the source of income is determined under paragraph (b)(6) of this section as income from sources within the United States, because A cannot establish the two points between which it is paid to transmit the communications.

Example 8. Income derived from communications and non-communications activity. (i) *Facts*. A, a U.S. company, offers customers local and long distance phone service, video, and Internet services. Customers pay one monthly fee, and in addition 10 cents a minute for all long-distance calls, including international calls.

(ii) *Analysis*. To the extent A derives income from communications activity, A must allocate income to its communications activity as provided in paragraph (d)(1)(ii) of this section. To the extent A can establish that it derives international communications income as defined in paragraph (d)(3)(ii) of this section, A would determine the source of such income under paragraph (b)(2)(i) of this section. If A cannot establish the points between which it is paid to transmit communications, as required in paragraph (d)(3)(i) of this section, the source of A's income must be determined under paragraph (b)(6) of this section as from within the United States.

Example 9. Income derived from communications activity. (i) *Facts*. T purchases capacity from TC to transmit telephone calls. T sells prepaid telephone calling cards, giving customers access to TC's lines, for a certain number of minutes.

(ii) *Analysis*. T derives income from communications activity, under paragraph (d)(2) of this section, because T makes capacity to transmit available to its customers. In this case, T cannot establish the points between which communications are transmitted. Therefore, the source of its income must be determined under paragraph (b)(6) of this section as U.S. source income.

Example 10. Income derived from communications and non-communications activity. (i) *Facts*. B, a U.S. company, transmits television programs using its satellite transponder, from the United States to downlink facilities in foreign country Y, owned by D, a cable system operator in Country Y. D receives the transmission, unscrambles the signals, and distributes the broadcast to customers in Country Y.

(ii) *Analysis*. B derives income both from communications activity as defined under paragraph (d)(1)(i) of this section, and from non-communications activity. Gross income must be allocated to the communications activity as required in paragraph (d)(1)(ii) of this section. Income derived by B for transmission to D is international communications income within paragraph (d)(3)(ii) of this section, because B is paid to transmit communications from the United States to a foreign country.

Example 11. Income derived from communications activity. (i) *Facts*. TC is paid for Internet access. TC replicates frequently requested sites on its servers, solely to speed up response time.

(ii) *Analysis*. On these facts, the replication service would be treated as de minimis under paragraph (d)(1)(i) of this section, so that TC derives income from communications activity. The type and source of TC's communications income depends on demonstrating the points between which TC is paid by its customer to transmit the communications, under paragraph (d)(3)(i) of this section.

Example 12. Income derived from foreign communications activity. (i) *Facts*. S leases capacity to

B, a broadcaster located in Australia. B beams programming to the satellite, and S's satellite picks the communications up in space, and beams the programming over Southeast Asia.

(ii) *Analysis.* S derives income from communications activity under paragraph (d)(2) of this section. S's income is characterized as income derived from foreign communications activity under paragraph (d)(3)(iv) of this section, because S picks up the communication in space, and beams it to a footprint entirely covering a foreign area. The source of S's income is determined under paragraph (b)(4) of this section as from sources without the United States. If S were beaming the programming over a satellite footprint that covered area both in the United States and outside the United States, S would be required to allocate the income derived from the different types of communications activity.

(g) *Reporting rules and disclosure on tax return.* When a taxpayer allocates gross income to the satisfaction of the Commissioner under paragraph (b)(2) (ii)(D), or (d)(1)(ii) of this section, it does so by making the allocation on a timely filed original return (including extensions). An amended return does not qualify for this purpose, nor shall the provisions of §301.9100-1 of this chapter and any guidance promulgated thereunder apply. In all cases, a taxpayer must maintain contemporaneous documentation in existence when such return is filed regarding the allocation of gross income, and allocation and apportionment of expenses, losses, and other deductions, the methodology used, and the circumstances justifying use of that methodology. The taxpayer must produce such documentation within 30 days of a request.

(h) *Effective date.* This section applies to taxable years beginning on or after the date that is 30 days after the date of publication of final regulations in the Federal Register.

Robert E. Wenzel,
*Deputy Commissioner
of Internal Revenue.*

(Filed by the Office of the Federal Register on January 16, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 17, 2001, 66 F.R. 3903)

Notice of Proposed Rulemaking and Notice of Public Hearing

Regulations Governing Practice Before the Internal Revenue Service

REG-111835-99

AGENCY: Office of the Secretary, Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This notice proposes modifications of the regulations governing practice before the Internal Revenue Service (Circular 230). These regulations would affect individuals who are eligible to practice before the Internal Revenue Service. The proposed modifications would clarify the general standards of practice before the Internal Revenue Service and would modify the standards for providing advice regarding tax shelters. This document also provides notice of a public hearing on the proposed regulations.

DATES: Comments and requests to speak and outlines of topics to be discussed from persons wishing to speak at the public hearing scheduled for May 2, 2001, in the auditorium of the Internal Revenue Building at 1111 Constitution Avenue, NW., Washington, DC 20224, must be received by April 12, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG-111835-99), room 5226, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 am. and 5 pm. to: CC:M&SP:RU (REG-111835-99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Submit comments and data via electronic mail (email) to http://www.irs.gov/tax_regs/regslst.html.

FOR FURTHER INFORMATION CONTACT: Concerning issues for comment, Richard Goldstein at (202) 622-7820 or Brinton Warren at (202) 622-4940; concerning submissions of comments and delivering comments, Guy Traynor at (202) 622-7180; (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507). Comments on the col-

lection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S:O, Washington, DC 20224. Comments on the collection of information should be received by March 13, 2001. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the Office of the Director of Practice, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proper collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in these proposed regulations is in §§10.6, 10.29, and 10.30. Section 10.6 requires an enrolled agent to maintain records and educational materials regarding his or her satisfaction of the qualifying continuing professional education credit. Section 10.6 also requires sponsors of qualifying continuing professional education programs to maintain records and educational material concerning these programs and those who attended them. The collection of this material helps to ensure that individuals enrolled to practice before the Internal Revenue Service are informed of the newest developments in Federal tax practice.

Section 10.29 requires a practitioner to obtain and retain for a reasonable period written consents to representation whenever such representation directly conflicts with the interests of the practitioner or the interests of another client of the practitioner. The consents are to be obtained after full disclosure of the conflict is pro-

vided to each party. Section 10.30 requires a practitioner to retain for a reasonable period any communication and the list of persons to whom that communication was provided with respect to public dissemination of fee information. The collection of consents to representation and communications concerning practitioner fees protects the practitioner against claims of impropriety and ensures the integrity of the tax administration system.

Estimated total annual recordkeeping burden is 50,000 hours.

Estimated annual burden per recordkeeper varies from 30 minutes to 1 hour, depending on individual circumstances, with an estimated average of 54 minutes.

Estimated number of recordkeepers is 56,000.

An agency may not conduct or sponsor, and a person is not required to respond to a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by section 6103 of the Internal Revenue Code.

Background

Section 330 of title 31 of the United States Code authorizes the Secretary of the Treasury to regulate the practice of representatives before the Treasury Department. The Secretary of the Treasury is authorized, after notice and an opportunity for a proceeding, to suspend or disbar from practice before the Department those representatives who are incompetent, disreputable, or who violate regulations prescribed under section 330 of title 31. Pursuant to section 330 of title 31, the Secretary has published the regulations in Circular 230 (31 CFR part 10). These regulations authorize the Director of Practice to act upon applications for enrollment to practice before the Internal Revenue Service, to make inquiries with respect to matters under the Director's jurisdiction, to institute proceedings for suspension or disbarment from practice before the Internal Revenue Service, and to perform such

other duties as are necessary to carry out these functions.

The regulations have been amended from time to time to address various specific issues in need of resolution. For example, on February 23, 1984, the regulations were amended to provide standards for providing opinions used in tax shelter offerings (49 FR 6719). On October 17, 1985, the regulations were amended to conform to legislative changes requiring the disqualification of an appraiser who is assessed a penalty under section 6701 of the Internal Revenue Code for aiding and abetting the understatement of a tax liability (50 FR 42014). The regulations were most recently amended on June 20, 1994 (59 FR 31523), to provide standards for tax return preparation, to limit the use of contingent fees in tax return or refund claim preparation, to provide expedited rules for suspension, and to clarify or amend certain other items.

On June 15, 1999, an advance notice of proposed rulemaking was published (64 FR 31994) requesting comments on amendments to the regulations that would take into account legal developments, professional integrity and fairness to practitioners, taxpayer service, and sound tax administration. On May 5, 2000, an advance notice of proposed rulemaking was published (65 FR 30375) requesting comments on amendments to the regulations relating to standards of practice governing tax shelters and other general matters.

Summary of Comments

Twenty-seven written comments have been submitted concerning the revision of Circular 230. All comments received have been considered and are available for public inspection upon request. The following paragraphs provide a summary of significant comments.

A few commentators expressed concern that, under the current regulations, a practitioner may be in violation of the regulations if the practitioner fails to furnish information or documents subject to a lawful request for documents made by an officer or employee of the Internal Revenue Service where neither the practitioner nor the practitioner's client possesses or controls the documents. These commentators suggested that §10.20 of

the regulations be clarified to provide that there is no violation of the regulations if the information or documents are not in the possession or control of the practitioner or the practitioner's client.

Some commentators expressed concern about a practitioner's obligation when notifying a client of any noncompliance with the revenue laws. The commentators recommended that a practitioner be required to advise the client of the action necessary to correct the error or omission and the consequences of not taking such action when notifying a client of any noncompliance with the revenue laws. Some commentators expressed concern about the current practice used by some practitioners to obtain oral consents to represent parties where there is a direct conflict of interest. They recommended that a practitioner be required to obtain written consents to represent parties where there is a direct conflict of interest.

Some commentators suggested that §10.22 be amended specifically to permit a practitioner to demonstrate due diligence for purposes of these regulations based on the practitioner's reliance on the work product of an associate or partner. It also was suggested that §10.24 be amended to permit a practitioner to share fees with a suspended or disbarred person during the period of suspension or disbarment, respectively.

Several commentators noted that the regulations regarding solicitation are not consistent with recent court decisions concerning in-person contacts of potential clients by certified public accountants. They suggested that the restrictions on in-person contacts be liberalized for all practitioners. It also was suggested that the prohibition of deceptive public solicitations be extended to deceptive private solicitations and that practitioners be prohibited from associating with an individual who uses deceptive solicitation practices, regardless of whether the deceptive practices related to business connected with the practitioner.

One commentator suggested that the regulations be modified to require the Director of Practice to notify a practitioner whenever a complaint has been filed against the practitioner, whether or not any action is taken against the practitioner as a result of the complaint.

Several comments were received recommending changes to the regulation of opinion writing by practitioners. Commentators recommended that new opinion standards be promulgated with respect to tax shelter opinions that are rendered for the purpose of establishing a reasonable cause and good faith defense to the accuracy-related penalties under section 6662 of the Internal Revenue Code ("reasonable cause opinions"). These commentators suggested that standards for such opinions impose factual due diligence requirements that, in particular, restrict the reliance on hypothetical facts or factual assumptions as the basis for such opinions. Some commentators suggested that reliance on factual assumptions regarding the business purpose or noneconomic consequences of a transaction be treated as inherently unreasonable. Comments also were received on whether and to what extent reliance in an opinion on taxpayer representations or certifications should be permitted and the conditions under which a practitioner may rely on the opinions of other practitioners.

Several commentators recommended that the new standards impose requirements with respect to the legal analysis contained in reasonable cause opinions, particularly that such opinions contain no unreasonable legal assumptions, address all material tax issues, evaluate relevant legal authorities and consider applicable judicial doctrines and statutory and regulatory anti-abuse rules. One commentator, however, thought it was unnecessary to impose an explicit requirement in Circular 230 that reasonable cause opinions address the applicability of relevant judicial doctrines. Another commentator considered it sufficient for Circular 230 merely to require that reasonable cause opinions consider the substance and purpose of the transaction under scrutiny.

Comments also were received as to whether a reasonable cause opinion should unambiguously opine on a comfort level of "more likely than not" or higher, should state that it is issued to establish reasonable cause, and other matters. A few commentators expressed concern that the definition of a tax shelter utilized in any opinion standards not be overly broad and that opinion standards under Circular 230 be coordinated with opinion-related requirements under the accuracy-related

penalties. One commentator suggested that the opinion standards provide that satisfaction of the standards would meet a practitioner's obligations under Circular 230, but would not determine the persuasiveness of, and the taxpayer's good faith reliance on, the opinion. Two commentators also suggested that standards be promulgated for written advice used for marketing purposes.

Commentators generally did not oppose the expansion of sanctions to encompass lesser sanctions such as censure. Commentators did not support attribution of practitioner misconduct to other members of the practitioner's firm. Several commentators, however, stated that in instances where there has been a knowing participation or acquiescence in such misconduct by other members of a firm or a pattern of abuse by members of a firm, sanctions extending beyond the individual practitioner may be appropriate.

The majority of commentators supported a contingent fee limitation with respect to original tax returns if the fee arrangement was contingent on the return position being sustained. Such fee arrangements may indicate an inappropriate reliance on the "audit lottery." The commentators believed that the same considerations were not as persuasive with respect to amended tax returns.

Commentators generally did not favor the imposition of restrictions in Circular 230 on confidentiality imposed on practitioners by clients or on clients by practitioners.

Explanation of Provisions

Who May Practice

Paragraph (d)(2) of §10.3 of the regulations provides a list of issues with respect to which an enrolled actuary is authorized to represent a taxpayer in limited practice before the Internal Revenue Service. This list of issues would be expanded under the proposed regulations to include issues involving 26 U.S.C. 419 (treatment of funded welfare benefits), 419A (qualified asset accounts), 420 (transfers of excess pension assets to retiree health accounts), 4972 (tax on nondeductible contributions to qualified employer plans), 4976 (taxes with respect to funded welfare benefit plans), and 4980 (tax on reversion of qualified plan assets to employer).

Enrollment

Section 10.6 of the regulations sets forth the conditions for renewal of enrollment to practice before the Internal Revenue Service. One condition for renewal of enrollment is that the enrolled agent complete a minimum number of hours of continuing professional education. Paragraph (f) of §10.6 of the regulations requires that there be a written outline and/or textbook for each course. Under the proposed regulations, a continuing education program may qualify for purposes of this part if the course requires suitable electronic educational materials, a written outline, or a textbook.

The regulations permit any individual who is enrolled as an actuary by the Joint Board for the Enrollment of Actuaries to enroll and qualify to practice before the Internal Revenue Service by filing with the Service a written declaration that such individual is currently qualified as an enrolled actuary. New paragraph 10.6(o) would be added to clarify that the renewal of enrollment of actuaries also is governed by the regulations concerning the Joint Board for the Enrollment of Actuaries at 20 C.F.R. 901.1 *et seq.*

Information to be Furnished

Section 10.20 of the regulations requires a practitioner to submit documents or information whenever a lawful request for such documents or information is made by a duly authorized officer or employee of the Internal Revenue Service. The provision does not provide an exception if the practitioner or the practitioner's client does not possess or control the requested documents or information. Under the proposed regulations, paragraph (a) of §10.20 would be modified to clarify that a practitioner is required to promptly respond to a lawful and proper request for documents by either submitting the requested information or advising the requesting officer or employee why the information cannot be provided (e.g., the documents requested are privileged, or the documents are not controlled by either the practitioner or the practitioner's client). If the documents are not controlled by either the practitioner or the practitioner's client, the provision would require the practitioner, to the extent possible, to identify any persons

who may have the requested documents in their control.

Knowledge of Client's Omission

Section 10.21 of the regulations requires a practitioner to advise a client promptly of any noncompliance by the client with the revenue laws. Under the proposed regulations, a practitioner also would be required to advise the client of the manner in which the error or omission may be corrected and the possible consequences of not taking such corrective action.

Diligence as to Accuracy

Section 10.22 of the regulations requires a practitioner to exercise due diligence in preparing or assisting in the preparation, approving, and filing of documents relating to Internal Revenue Service matters. Section 10.22 also requires a practitioner to exercise due diligence in determining the correctness of oral or written representations made to the Department of Treasury or with reference to any matter administered by the Internal Revenue Service. The proposed regulations would clarify that a practitioner is presumed to have exercised due diligence if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training and evaluating such person.

Assistance from Disbarred or Suspended Persons

Section 10.24 of the regulations prohibits a practitioner, in practice before the Internal Revenue Service, from employing, accepting assistance from, accepting employment from, or becoming a subagent for, a disbarred or suspended person. Section 10.24 also precludes a practitioner from accepting assistance from any former government employee where the provisions of §10.26 of the current regulations (§10.25 of the proposed regulations) or any Federal law would be violated. Section 10.24 of the proposed regulations clarifies that a practitioner is prohibited from accepting assistance from or assisting a disbarred or suspended practitioner if the assistance relates to matters constituting practice before the Internal Revenue Service. The proposed regula-

tions, however, would not require practitioners to disassociate themselves from a suspended or disbarred person as long as the other proscriptions regarding disbarred or suspended persons are observed. Practitioners who are partners of a law or accountancy partnership, for example, would not be required to expel another partner who was subject to discipline simply because the disciplined partner might otherwise share in fees derived from services rendered by others before the Internal Revenue Service.

Practice by Partners of Government Employees

Section 10.25 of the regulations precludes partners of former Government employees from practice with respect to matters in which the employee personally and substantially participated. This provision would be removed under the proposed regulations because the statutory prohibition implemented by this provision (18 U.S.C. 207(c)) has been repealed.

Practice by Former Government Employees, Their Partners and Their Associates

Section 10.26 of the current regulations places restrictions on the practice of former Government employees, their partners, and their associates with respect to certain matters that the former Government employees participated in during the course of their Government employment. This section would be renumbered as §10.25 under the proposed regulations and would be amended to reflect changes to the Federal statutes governing post-employment restrictions applicable to former Government employees.

Fees and Confidentiality

Paragraph (b) of §10.28 of the current regulations precludes a practitioner from charging his or her client a contingent fee for the preparation of an original tax return, but permits the practitioner to charge a contingent fee for the preparation of an amended tax return or a claim for refund (other than a claim for refund made on an original tax return). Section 10.28 would be renumbered as §10.27 and paragraph (b) would be clarified to provide that a practitioner is prohibited from

charging a contingent fee not only for preparation of an original tax return, but also for advice rendered in connection with a position taken or to be taken on an original tax return. A practitioner would be permitted, however, to charge a contingent fee both for the preparation of, and for advice rendered in connection with a position taken, or to be taken on, an amended tax return or a claim for refund if the practitioner reasonably anticipates that the amended tax return or refund claim will receive substantive review by the Internal Revenue Service. In addition, a contingent fee would be defined to include any fee that is based, in whole or in part, on whether or not a position taken on a tax return or in a refund claim is sustained, an indemnity agreement, a guarantee, rescission rights, insurance or any other arrangement by which the practitioner will compensate or reimburse the taxpayer or another person if a position taken on a tax return or in a refund claim is not sustained.

The proposed regulations would not prohibit confidentiality agreements. Confidentiality restrictions imposed by clients may raise an ethical inquiry as to the effects of such arrangements on a practitioner's ability to represent his or her clients. See Illinois State Bar Association Advisory Opinion on Professional Conduct 00-01 (October 2000)(a conflict of interest arises with respect to other similar clients when a lawyer agrees not to disclose ideas of a third party to reduce a client's tax obligations). Commentators asserted that such confidentiality restrictions were not an issue appropriate for regulation under Circular 230. Commentators also asserted that confidentiality restrictions imposed by practitioners on clients were an appropriate contractual arrangement for the benefit of practitioners. The Treasury Department remains concerned, however, about confidentiality restrictions and specifically invites comments on whether the final regulations should address such restrictions, and, if so, in what manner.

Return of Client's Records

Section 10.28 of the proposed regulations would specifically require a practitioner to return a client's records when the client makes a request for such records, whether or not a dispute regarding fees

exists. The practitioner may retain a copy of those records.

Conflicting Interests

Section 10.29 of the regulations prohibits a practitioner from representing conflicting interests before the Internal Revenue Service, except with the express consent of all directly interested parties after full disclosure. Under the proposed regulations, a practitioner would be required to obtain the written consents of the clients before representing clients with conflicting interests. The practitioner would be required to retain the written consents for at least 36 months after the conclusion of the representation of the clients and to present copies of such consents to the Internal Revenue Service, if requested to do so.

In addition, the proposed regulations would provide that a practitioner may not represent a party in his or her practice before the Internal Revenue Service if that representation may be materially limited by the practitioner's own interests, unless the practitioner reasonably believes the representation will not be adversely affected and the client consents after full disclosure, including disclosure of the implications of the potential conflict and the risks involved.

Solicitation

Section 10.30 of the regulations governs the manner in which practitioners may contact potential business clients. The proposed regulations would update the solicitation rules to reflect recent court decisions and to respond to comments received in connection with this rulemaking. Under the proposed regulations, a practitioner would be permitted to contact potential business clients using any medium that is not prohibited by Federal or state statutes or other rules applicable to the practitioner regarding the uninvited solicitation of prospective clients. The proposed regulations also would expand the prohibition of deceptive solicitation practices to cover private, as well as public, solicitations, expand the prohibition against providing assistance to or accepting assistance from an individual who uses deceptive solicitation practices, whether or not such practices are in connection with the relationship the individ-

ual has with the practitioner, and include electronic mail, facsimile, and hand-delivered flyers in the definition of communication.

Negotiation of Taxpayer Checks

Section 10.31 of the regulations prohibits a practitioner who prepares income tax returns from negotiating a check with respect to income tax issued to a taxpayer other than the practitioner. The proposed regulations would clarify that this prohibition is not limited to checks issued for income taxes, but applies to all checks issued to the practitioner's clients by the Government with respect to matters before the Internal Revenue Service. The proposed regulations also would clarify that practitioners are not prohibited from negotiating checks issued to their own partnerships, corporations, etc.

Tax Shelter Opinions

Two sections of the proposed regulations would provide standards governing tax shelter opinions. New §10.35 would apply to all tax shelter opinions that conclude that the Federal tax treatment of a tax shelter item or items is more likely than not (or at a higher level of confidence) the proper treatment. Section 10.33 would be revised in scope to apply to all tax shelter opinions not governed by §10.35 that a practitioner knows or has reason to believe will be used or referred to by persons other than the practitioner to promote, market or recommend a tax shelter. For purposes of §§10.33 and 10.35 of the proposed regulations, the definition of a tax shelter would conform to the definition found in section 6662(d)(2)(C)(iii) of the Internal Revenue Code.

The Treasury Department and the Internal Revenue Service recognize that the proposed rules in §§10.33 and 10.35 of the proposed regulations may regulate opinion standards with respect to transactions that had not previously been subject to the rules governing tax shelter opinions. The proposed regulations would exclude opinions relating to municipal bonds and qualified retirement plans. The Treasury Department and the Internal Revenue Service specifically request comment on whether the regulations should exempt other transactions from the requirements for tax shelter opinions and,

if so, the types of other transactions that should be exempted.

Tax Shelter Opinions Used by Third Parties to Market Tax Shelters

Section 10.33 currently governs advice by a practitioner concerning the Federal tax aspects of a tax shelter either appearing or referred to in offering materials, or used or referred to in connection with sales promotion efforts, and directed to persons other than the client who engaged the practitioner to give the advice. The proposed regulations would revise the scope of §10.33 to govern a tax shelter opinion that does not conclude that the Federal tax treatment of an item or items is more likely than not the proper treatment and that a practitioner knows or has reason to believe will be used or referred to by persons other than the practitioner to promote, market or recommend the tax shelter to one or more taxpayers. The proposed regulations would clarify that §10.33 governs tax shelter opinions prepared for use by third parties that are promoting the tax shelter, irrespective of whether such promotional efforts are conducted publicly or privately. The proposed regulations also would modify the definition of a material Federal tax issue and define a tax shelter item as an item of income, gain, loss, deduction or credit if the item is directly or indirectly attributable to a tax shelter.

Section 10.33 would require a practitioner who provides a written opinion with respect to a tax shelter item or items to comply with a series of requirements with respect to each such item. A practitioner would be required to make inquiry as to all relevant facts, be satisfied that the opinion takes account of all relevant facts, and that the material facts are accurately and completely described in the opinion. Furthermore, the opinion could not be based, directly or indirectly, on any unreasonable factual assumptions. An unreasonable factual assumption would include a factual assumption that the practitioner knows or has reason to believe is incorrect, incomplete, inconsistent or implausible. An unreasonable factual assumption also would include a factual assumption regarding a fact or facts that the practitioner could reasonably request to be provided or to be represented.

The proposed regulations would permit a practitioner, where it would be reasonable based on all the facts and circumstances, to rely upon factual representations, statements, findings or agreements. The proposed regulations would further provide that a practitioner need not conduct an audit or independent verification of a factual representation, but that reliance would not be permitted on factual representations that the practitioner knows or has reason to believe are unreasonable, incorrect, incomplete, inconsistent or implausible (e.g., a representation that there are business reasons for a transaction without describing those reasons, a representation that a transaction is potentially profitable apart from tax benefits without providing adequate factual support, or a valuation that is inconsistent with the facts of the transaction).

The proposed regulations would provide that the opinion must clearly identify the facts upon which the opinion's conclusions are based, contain a reasoned analysis of the pertinent facts and legal authorities and not assume the favorable resolution of any Federal tax issue material to the analysis or otherwise rely on unreasonable legal assumptions. The proposed regulations also would require that the opinion not contain legal analyses or conclusions that are inconsistent with each other.

The practitioner would be required to ascertain that all material Federal tax issues with respect to the tax shelter item or items have been considered and that all of those material Federal tax issues involving the reasonable possibility of a challenge by the Internal Revenue Service are fully and fairly addressed. The opinion would be required to state that the practitioner has considered the possible application to the facts of all potentially relevant judicial doctrines, including the step transaction, business purpose, economic substance, substance over form, and sham transaction doctrines, as well as potentially relevant statutory and regulatory anti-abuse rules, and the opinion must analyze whether the tax shelter item or items is (are) vulnerable to challenge under all such potentially relevant doctrines and anti-abuse rules.

The proposed regulations would require that the opinion clearly provide the practitioner's conclusion as to the likelihood that a typical investor of the

type to whom the tax shelter is or will be marketed will prevail with respect to the merits of each material Federal tax issue that involves the reasonable possibility of a challenge by the Internal Revenue Service or clearly state that the practitioner is unable to reach a conclusion with respect to one or more issues. Further, the opinion would be required to fully describe the reasons for the practitioner's conclusions or fully describe the reasons for the inability to reach a conclusion.

The practitioner would be required to reach an overall conclusion as to the likelihood that the Federal tax treatment of the tax shelter item or items is the proper treatment or, where the practitioner is unable to reach such a conclusion, clearly state that the practitioner is unable to reach such an overall conclusion. Where an overall conclusion cannot be reached, the opinion would be required to fully describe the reasons for the practitioner's inability to reach an overall conclusion. Moreover, the fact that the practitioner's opinion does not reach a conclusion that the Federal tax treatment of a tax shelter item or items is more likely than not the proper treatment, or that the practitioner is unable to reach an overall conclusion, would be required to be clearly and prominently disclosed on the first page of the opinion. The opinion also would be required to clearly and prominently disclose that it was not written for the purpose of establishing reasonable belief or reasonable cause and good faith under sections 6662 and 6664, respectively, of the Internal Revenue Code. The proposed regulations also would clarify that in ascertaining that all material Federal tax issues have been considered, evaluating the merits of those issues and evaluating whether the Federal tax treatment of the tax shelter item or items is the proper treatment, the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.

The proposed regulations would require the practitioner to take reasonable steps to assure that any written materials or promotional efforts that distribute, reflect or refer to the tax shelter opinion correctly and fairly represent the nature and extent of the opinion.

The proposed regulations also would address reliance on the opinions of others.

The proposed regulations would require that the practitioner be knowledgeable in all of the aspects of Federal tax law relevant to the opinion being rendered. A practitioner would not be permitted to provide a tax shelter opinion that does not reach a conclusion on all the material Federal tax issues that involve a reasonable possibility of challenge by the Internal Revenue Service or does not reach an overall conclusion (or, alternatively, fails to clearly state that such conclusions cannot be reached), unless at least one other competent practitioner provides an opinion with respect to all of the other material Federal tax issues which involve a reasonable possibility of challenge by the Internal Revenue Service, and with respect to the tax shelter item or items. The practitioner also would be required, upon reviewing such other opinion and any written materials that distribute, reflect or refer to such opinion, to have no reason to believe that the other practitioner has not complied with §10.33 or that the overall conclusion reached by such practitioner is incorrect on its face.

"More Likely Than Not" Tax Shelter Opinions

Under the proposed regulations, new standards would be applicable to practitioners who provide tax shelter opinions that conclude that the Federal tax treatment of a tax shelter item or items is more likely than not (or at a higher level of confidence) the proper treatment. Such opinions potentially provide a basis for establishing reasonable belief and reasonable cause and good faith under the provisions of sections 6662 and 6664 of the Internal Revenue Code, respectively. These proposed rules would apply to all tax shelter opinions that reach a more likely or not, or higher, overall conclusion, regardless of whether they were rendered in connection with promotional efforts conducted by a third party or directly to a potential tax shelter investor. The proposed regulations also would define a material Federal tax issue. A tax shelter item would be defined in the same manner as in §10.33.

Section 10.35 would require a practitioner who provides a written opinion with respect to a tax shelter item or items to comply with a series of requirements with respect to each such item. A practitioner would be required to make inquiry

as to all relevant facts, be satisfied that the opinion takes account of all relevant facts, and be satisfied that the material facts are accurately and completely described in the opinion. Furthermore, the opinion could not be based, directly or indirectly, on any unreasonable factual assumptions. An unreasonable factual assumption would include a factual assumption that the practitioner knows or has reason to believe is incorrect, incomplete, inconsistent or implausible. An unreasonable factual assumption also would include a factual assumption regarding a fact or facts that the practitioner could reasonably request to be provided or to be represented. Furthermore, an unreasonable factual assumption would include a factual assumption that the transaction has a business reason, an assumption with respect to the potential profitability of the transaction apart from tax benefits, or an assumption with respect to a material valuation issue.

The proposed regulations would permit a practitioner, where it would be reasonable based on all the facts and circumstances, to rely on factual representations, statements, findings, or agreements of the taxpayer or other persons. The proposed regulations would further provide that a practitioner need not conduct an audit or independent verification of a factual representation, but that reliance would not be permitted on factual representations that the practitioner knows or has reason to believe are unreasonable, incorrect, incomplete, inconsistent or implausible (e.g., a representation that there are business reasons for a transaction without describing those reasons, a representation that a transaction is potentially profitable apart from tax benefits without providing adequate factual support, or a valuation that is inconsistent with the facts of the transaction).

The proposed regulations would provide that the opinion must clearly identify the facts upon which the opinion's conclusions are based, contain a reasoned analysis of the pertinent facts and legal authorities and not assume the favorable resolution of any Federal tax issue material to the analysis or otherwise rely on unreasonable factual assumptions. The proposed regulations also would require that the opinion not contain legal analysis or conclusions that are inconsistent with each other.

The practitioner would be required to ascertain that all material Federal tax issues with respect to the tax shelter item or items have been considered and that all of those material Federal tax issues involving the reasonable possibility of a challenge by the Internal Revenue Service are fully and fairly addressed. The opinion would be required to state that the practitioner has considered the possible application to the facts of all potentially relevant judicial doctrines, including the step transaction, business purpose, economic substance, substance over form, and sham transaction doctrines, as well as potentially relevant statutory and regulatory anti-abuse rules, and the opinion must analyze whether the tax shelter item or items is (are) vulnerable to challenge under all such potentially relevant doctrines and anti-abuse rules.

The proposed regulations would require that the opinion clearly provide the practitioner's conclusion as to the likelihood that the taxpayer will prevail with respect to the merits of each material Federal tax issue that involves a reasonable possibility of challenge by the Internal Revenue Service and must unambiguously conclude that the Federal tax treatment of the tax shelter item or items more likely than not (or at a higher level of confidence) is the proper treatment. The proposed regulations also would clarify that in ascertaining that all material Federal tax issues have been considered, evaluating the merits of those issues and evaluating whether the Federal tax treatment of the tax shelter item or items is the proper treatment, the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.

The proposed regulations would require the practitioner to take reasonable steps to assure that any written materials or promotional efforts that distribute, reflect or refer to the tax shelter opinion correctly and fairly represent the nature and extent of the opinion. The proposed regulations also would require that the practitioner be knowledgeable in all of the relevant aspects of Federal tax law at the time the opinion is rendered. The practitioner who is providing an overall conclusion that the Federal tax treatment of a tax shelter item or items more likely than not

(or at a higher level of confidence) is the proper treatment may rely on the opinion of another practitioner with respect to certain issues only if the practitioner is satisfied that the other practitioner is sufficiently knowledgeable regarding such issues and the practitioner has no reason to believe that such opinion should not be relied upon. To the extent the practitioner relies on such opinion, the opinion rendered by the practitioner must identify the other practitioner, state the date on which the opinion was rendered, and set forth the conclusions reached in such opinion. Furthermore, the practitioner must be satisfied that the combined analysis, taken as a whole, satisfies the requirements of this §10.35.

The Treasury Department and the Internal Revenue Service intend to modify the advice standards in the regulations under section 6662 of the Internal Revenue Code (pertaining to whether a taxpayer other than a corporation reasonably believed at the time a tax return was filed that the tax treatment of a tax shelter item was more likely than not the proper treatment of that item) and under section 6664 of the Internal Revenue Code (pertaining to whether a taxpayer acted with reasonable cause and in good faith with respect to a tax shelter item) to provide that opinions can satisfy those standards only if such opinions satisfy the standards of Circular 230.

Procedures to Ensure Compliance

Section 10.36 of the proposed regulations provides that a practitioner who is a member of, associated with, or employed by a firm must take reasonable steps, consistent with his or her authority and responsibility for the firm's practice advising clients regarding matters arising under the Federal tax laws, to make certain that the firm has adequate procedures in effect for purposes of ensuring compliance with §§10.33, 10.34 and 10.35. The Director of Practice would be authorized to take disciplinary action against any practitioner for failing to comply with this requirement if the practitioner through willfulness, recklessness, or gross incompetence does not take such reasonable steps and one or more persons who are members of, associated with, or employed by the firm have, while they were members of, associated with, or employed

by the firm, engaged in a pattern or practice of failing to comply with §§10.33, 10.34 or 10.35. The Director of Practice also would be authorized to take disciplinary action against any practitioner who takes such steps but has actual knowledge that one or more persons who are members of, associated with, or employed by the firm have, while they were members of, associated with, or employed by the firm, engaged in a pattern or practice of failing to comply with §§10.33, 10.34 or 10.35 and the practitioner through willfulness, recklessness, or gross incompetence fails to take prompt action, consistent with his or her authority and responsibility for the firm's practice advising clients regarding matters under the Federal tax law, to correct such pattern or practice.

Sanctions

Section 10.50 of the regulations authorizes the Secretary of the Treasury to disbar or suspend any practitioner from practice before the Internal Revenue Service after notice and an opportunity for a proceeding. Under the proposed regulations, the Secretary also would be permitted to censure the practitioner after notice and an opportunity for a proceeding. Censure is a public reprimand. Additionally, the authority to disqualify an appraiser would be relocated to paragraph (b) of §10.50 of the regulations.

Disreputable Conduct

Section 10.51 of the regulations defines disreputable conduct for which a practitioner may be disbarred or suspended. The proposed regulations would provide that a practitioner who engages in disreputable conduct also may be censured. The definition of disreputable conduct also would be modified to include conviction of any felony involving conduct that renders the practitioner unfit to practice before the Internal Revenue Service.

Institution of Proceeding

Section 10.54 authorizes the Director of Practice to institute a proceeding to suspend or disbar a practitioner if the Director believes the practitioner has violated any provisions of the laws or regulations governing practice before the Internal Revenue Service. The section would be renumbered as §10.60 under the proposed regulations and would specify

that the Director of Practice also may institute a proceeding to censure the practitioner if the Director believes the practitioner has violated any provisions of the laws or regulations governing practice before the Internal Revenue Service. Under the proposed regulations, the procedures set forth in §10.60 would apply to proceedings to disqualify an appraiser.

Conferences

Section 10.55 authorizes the Director of Practice to confer with a practitioner regarding allegations of misconduct. The provision permits a practitioner to offer his or her consent to voluntary suspension to prevent the institution or conclusion of a disbarment proceeding. The provision would be renumbered as §10.61 and would be changed to permit a practitioner to also offer his or her consent to censure to prevent the institution or conclusion of a disbarment proceeding. The provision also would apply to conferences with an appraiser regarding allegations of misconduct and would permit the appraiser to offer his or her voluntary consent to disqualification.

Service of Complaint and Other Papers

Sections 10.57 and 10.80 of the regulations permit the Director of Practice to serve a complaint or any other paper upon a practitioner or appraiser by certified mail. If the certified mail is not claimed, the Director of Practice may serve the complaint by first class mail. The proposed regulations would consolidate these provisions under §10.63 and would specify that service by first class mail is complete if the complaint is mailed to the practitioner or appraiser at his or her last known address as determined under section 6212 of the Internal Revenue Code.

Answer

Sections 10.58 and 10.81 of the regulations require a practitioner or an appraiser to file an Answer whenever the Director of Practice files a complaint against him or her under the regulations. These provisions also establish the time for filing an Answer and prescribe certain requirements as to the content of an Answer. The proposed regulations would consolidate these provisions under §10.64, which section would require that the Answer to the complaint be signed by

the respondent or the respondent's authorized representative and include an acknowledgment that knowing and willful false statements may be punishable under 18 U.S.C. 1001.

Reply to Answer

Sections 10.60 and 10.83 permit the Director of Practice to file a reply to the respondent's answer at the Director's discretion or at the request of the Administrative Law Judge. Under the proposed regulations, these provisions would be consolidated under §10.66 and that section would require the Director of Practice to file a reply to the respondent's answer if the Administrative Law Judge orders that a reply be filed.

Motions and Requests

Sections 10.62 and 10.85 of the regulations permit the Director of Practice and the respondent to file motions and requests in hearings before an Administrative Law Judge with the Director or the Administrative Law Judge. Under the proposed regulations, these provisions would be consolidated under §10.68 and would clarify that the Administrative Law Judge may direct that motions or requests be filed at a place specified by the Administrative Law Judge.

Effect of Disbarment, Suspension, or Censure

Section 10.73 of the regulations prohibits a disbarred practitioner from practicing before the Internal Revenue Service unless and until authorized to do so by the Director of Practice. The regulations also prohibit a suspended practitioner from practicing before the Internal Revenue Service during the period of suspension. Under the proposed regulations, this section would be renumbered as §10.79 and would also provide that the Director of Practice may make a practitioner's future right to practice before the Internal Revenue Service subject to his or her meeting certain conditions designed to promote high standards of conduct.

Expedited Suspension Upon Criminal Conviction or Loss of License for Cause

Paragraph (b)(2) of §10.76 of the regulations permits the Director of Practice to institute a proceeding to suspend any

practitioner who has, within 5 years of the date on which the complaint instituting the proceeding is served, been convicted of any crime under title 26 of the United States Code or a felony under title 18 of the United States Code involving dishonesty or breach of trust. Under the proposed regulations this provision would be renumbered as §10.82 and would permit the Director of Practice to institute a proceeding to suspend any practitioner who has been convicted of any crime under the Internal Revenue Code, any crime involving dishonesty or breach of trust (regardless of whether such crime constituted a felony under title 18 of the United States Code), or any felony that involved conduct that renders the practitioner unfit to practice before the Internal Revenue Service (regardless of whether such felony was pursuant to title 18 of the United States Code or involved dishonesty or breach of trust).

Consolidation of Appraiser Disqualification Rules

The current regulations contain, in separate provisions, virtually identical rules applicable to disciplinary proceedings against practitioners and appraisers. The proposed rules would consolidate the rules regarding sanctions of practitioners and appraisers under subpart C and the rules regarding the conduct of disciplinary proceedings under subpart D.

Proposed Effective Date

These regulations are proposed to apply on the date that final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities because the general requirements, including the collection of information requirements, of these regulations are substantially the same as the requirements of the regulations that these regulations will replace. Persons authorized to practice have long been required to comply with certain standards of con-

duct when practicing before the Internal Revenue Service. These regulations do not alter the basic nature of the obligations and responsibilities of these practitioners. These regulations clarify those obligations in response to public comments and judicial decisions, and make other modifications to reflect the development of electronic media. In addition, the added requirements for tax shelter opinions imposed by these regulations will have no impact on the substantial number of small entities who have been satisfying these requirements when they provide such opinions. Therefore, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before the regulations are adopted as final regulations, consideration will be given to any written comments and electronic comments that are submitted timely to the Internal Revenue Service. The Internal Revenue Service and Treasury Department specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

The public hearing is scheduled for May 2, 2001, from 8 am. to 11 am., and will be held in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. All visitors must present photo identification to enter the building. Visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an out-

line of the topics to be discussed and the time to be devoted to each topic by April 12, 2001. A period of 10 minutes will be allocated to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Richard S. Goldstein and Brinton Warren, Office of Associate Chief Counsel (Procedure & Administration), Administrative Provisions and Judicial Practice Division, but other personnel from the Internal Revenue Service and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 31 CFR part 10 is proposed to be revised to read as follows:

PART 10 — PRACTICE BEFORE THE INTERNAL REVENUE SERVICE

Sec.

10.0 Scope of part.

Subpart A—Rules Governing Authority to Practice

- 10.1 Director of Practice.
- 10.2 Definitions.
- 10.3 Who may practice.
- 10.4 Eligibility for enrollment.
- 10.5 Application for enrollment.
- 10.6 Enrollment.
- 10.7 Representing oneself; participating in rulemaking; limited practice; special appearances; and return preparation.
- 10.8 Customhouse brokers.

Subpart B—Duties and Restrictions Relating to Practice Before the Internal Revenue Service

- 10.20 Information to be furnished.
- 10.21 Knowledge of client's omission.
- 10.22 Diligence as to accuracy.
- 10.23 Prompt disposition of pending matters.
- 10.24 Assistance from or to disbarred or suspended persons and former

- Internal Revenue Service employees.
- 10.25 Practice by former Government employees, their partners and their associates.
- 10.26 Notaries.
- 10.27 Fees.
- 10.28 Return of client's records.
- 10.29 Conflicting interests.
- 10.30 Solicitation.
- 10.31 Negotiation of taxpayer checks.
- 10.32 Practice of law.
- 10.33 Tax shelter opinions used by third parties to market tax shelters.
- 10.34 Standards for advising with respect to tax return positions and for preparing or signing returns.
- 10.35 More likely than not tax shelter opinions.
- 10.36 Procedures to ensure compliance.

Subpart C—Sanctions for Violation of the Regulations

- 10.50 Sanctions.
- 10.51 Incompetence and disreputable conduct.
- 10.52 Violation of regulations.
- 10.53 Receipt of information concerning practitioner.

Subpart D—Rules Applicable to Disciplinary Proceedings

- 10.60 Institution of proceeding.
- 10.61 Conferences.
- 10.62 Contents of complaint.
- 10.63 Service of complaint and other papers.
- 10.64 Answer.
- 10.65 Supplemental charges.
- 10.66 Reply to answer.
- 10.67 Proof; variance; amendment of pleadings.
- 10.68 Motions and requests.
- 10.69 Representation.
- 10.70 Administrative Law Judge.
- 10.71 Hearings.
- 10.72 Evidence.
- 10.73 Depositions.
- 10.74 Transcript.
- 10.75 Proposed findings and conclusions.
- 10.76 Decision of the Administrative Law Judge.
- 10.77 Appeal to the Secretary.
- 10.78 Decision of the Secretary.
- 10.79 Effect of disbarment, suspension, or censure.
- 10.80 Notice of disbarment, suspension, censure, or disqualification.

- 10.81 Petition for reinstatement.
- 10.82 Expedited suspension upon criminal conviction or loss of license for cause.

Subpart E—General Provisions

- 10.90 Records.
 - 10.91 Saving clause.
 - 10.92 Special orders.
 - 10.93 Effective date.
- Authority: Sec. 3, 23 Stat. 258, secs. 2–12, 60 Stat. 237 et seq.; 5 U.S.C. 301, 500, 551–559; 31 U.S.C. 330; Reorg. Plan No. 26 of 1950, 15 FR 4935, 64 Stat. 1280, 3 CFR, 1949–1953 Comp., P. 1017.

§10.0 Scope of part.

This part contains rules governing the recognition of attorneys, certified public accountants, enrolled agents, and other persons representing taxpayers before the Internal Revenue Service. Subpart A of this part sets forth rules relating to authority to practice before the Internal Revenue Service; subpart B of this part prescribes the duties and restrictions relating to such practice; subpart C of this part prescribes the sanctions for violating the regulations; subpart D of this part contains the rules applicable to disciplinary proceedings; and subpart E of this part contains general provisions including provisions relating to the availability of official records.

Subpart A — Rules Governing Authority to Practice

§10.1 Director of Practice.

(a) *Establishment of office.* The office of the Director of Practice is established in the Office of the Secretary of the Treasury. The Director of Practice is appointed by the Secretary of the Treasury, or his or her designate.

(b) *Duties.* The Director of Practice acts on applications for enrollment to practice before the Internal Revenue Service; makes inquiries with respect to matters under his or her jurisdiction; institutes and provides for the conduct of disciplinary proceedings relating to attorneys, certified public accountants, enrolled agents, enrolled actuaries and appraisers; and performs other duties as are necessary or appropriate to carry out his or her functions under this part or as are prescribed by the Secretary of the Treasury, or his or her designate.

(c) *Acting Director of Practice.* The Secretary of the Treasury, or his or her designate, will designate an officer or employee of the Treasury Department to act as Director of Practice in the absence of the Director or a vacancy in that office.

§10.2 Definitions.

As used in this part, except where the context clearly indicates otherwise:

(a) *Attorney* means any person who is a member in good standing of the bar of the highest court of any State, possession, territory, Commonwealth, or the District of Columbia.

(b) *Certified public accountant* means any person who is duly qualified to practice as a certified public accountant in any State, possession, territory, Commonwealth, or the District of Columbia.

(c) *Commissioner* refers to the Commissioner of Internal Revenue.

(d) *Director* refers to the Director of Practice.

(e) *Practice before the Internal Revenue Service* comprehends all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, and representing a client at conferences, hearings, and meetings.

(f) *Practitioner* means any individual described in paragraphs (a), (b), (c), or (d) of section 10.3 of this part.

(g) A *tax return* includes an amended tax return and a claim for refund.

(h) *Service* means the Internal Revenue Service.

§10.3 Who may practice.

(a) *Attorneys.* Any attorney who is not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Service by filing with the Service a written declaration that he or she is currently qualified as an attorney and is authorized to represent the party(ies) on whose behalf he or she acts.

(b) *Certified public accountants.* Any certified public accountant who is not currently under suspension or disbarment

from practice before the Internal Revenue Service may practice before the Service by filing with the Service a written declaration that he or she is currently qualified as a certified public accountant and is authorized to represent the party(ies) on whose behalf he or she acts.

(c) *Enrolled agents.* Any individual enrolled as an agent pursuant to this part who is not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Service.

(d) *Enrolled actuaries.* (1) Any individual who is enrolled as an actuary by the Joint Board for the Enrollment of Actuaries pursuant to 29 U.S.C. 1242 who is not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Service by filing with the Service a written declaration stating that he or she is currently qualified as an enrolled actuary and is authorized to represent the party(ies) on whose behalf he or she acts.

(2) Practice as an enrolled actuary is limited to representation with respect to issues involving the following statutory provisions in title 26 of the United States Code: sections 401 (relating to qualification of employee plans), 403(a) (relating to whether an annuity plan meets the requirements of section 404(a)(2)), 404 (relating to deductibility of employer contributions), 405 (relating to qualification of bond purchase plans), 412 (relating to funding requirements for certain employee plans), 413 (relating to application of qualification requirements to collectively bargained plans and to plans maintained by more than one employer), 414 (relating to definitions and special rules with respect to the employee plan area), 419 (relating to treatment of funded welfare benefits), 419A (relating to qualified asset accounts), 420 (relating to transfers of excess pension assets to retiree health accounts), 4971 (relating to excise taxes payable as a result of an accumulated funding deficiency under section 412), 4972 (relating to tax on nondeductible contributions to qualified employer plans), 4976 (relating to taxes with respect to funded welfare benefit plans), 4980 (relating to tax on reversion of qualified plan assets to employer), 6057 (relating to annual registration of plans), 6058 (relating to information required in connection

with certain plans of deferred compensation), 6059 (relating to periodic report of actuary), 6652(e) (relating to the failure to file annual registration and other notifications by pension plan), 6652(f) (relating to the failure to file information required in connection with certain plans of deferred compensation), 6692 (relating to the failure to file actuarial report), and 7805(b) (relating to the extent to which a Internal Revenue Service ruling or determination letter coming under the statutory provisions listed here will be applied without retroactive effect); and 29 U.S.C. 1083 (relating to the waiver of funding for non-qualified plans).

(3) An individual who practices before the Internal Revenue Service pursuant to paragraph (d)(1) of this section is subject to the provisions of this part in the same manner as attorneys, certified public accountants and enrolled agents.

(e) *Others.* Any individual qualifying under paragraph (c) of §10.5 or §10.7 is eligible to practice before the Internal Revenue Service to the extent provided in those sections.

(f) *Government officers and employees, and others.* An individual, who is an officer or employee of the executive, legislative, or judicial branch of the United States Government; an officer or employee of the District of Columbia; a Member of Congress; or a Resident Commissioner may not practice before the Internal Revenue Service if such practice violates 18 U.S.C. 203 or 205.

(g) *State officers and employees.* No officer or employee of any State, or subdivision of any State, whose duties require him or her to pass upon, investigate, or deal with tax matters for such State or subdivision, may practice before the Internal Revenue Service, if such employment may disclose facts or information applicable to Federal tax matters.

§10.4 Eligibility for enrollment.

(a) *Enrollment upon examination.* The Director of Practice may grant enrollment to an applicant who demonstrates special competence in tax matters by written examination administered by, or administered under the oversight of, the Director and who has not engaged in any conduct that would justify the censure, suspension, or disbarment of any practitioner under the provisions of this part.

(b) *Enrollment of former Internal Revenue Service employees.* The Director of Practice may grant enrollment to an applicant who, by virtue of his or her past service and technical experience in the Internal Revenue Service, has qualified for such enrollment and who has not engaged in any conduct that would justify the censure, suspension, or disbarment of any practitioner under the provisions of this part, under the following circumstances—

(1) The former employee applies for enrollment to the Director of Practice on a form supplied by the Director and supplies the information requested on the form and such other information regarding the experience and training of the applicant as may be relevant.

(2) An appropriate office of the Internal Revenue Service, at the request of the Director of Practice, will provide the Director with a detailed report of the nature and rating of the applicant's work while employed by the Service and a recommendation whether such employment qualifies the applicant technically or otherwise for the desired authorization.

(3) Enrollment based on an applicant's former employment with the Internal Revenue Service may be of unlimited scope or it may be limited to permit the presentation of matters only of the particular class or only before the particular unit or division of the Service for which the applicant's former employment has qualified the applicant.

(4) Application for enrollment based on an applicant's former employment with the Internal Revenue Service must be made within 3 years from the date of separation from such employment.

(5) An applicant for enrollment who is requesting such enrollment based on his or her former employment with the Internal Revenue Service must have had a minimum of 5 years continuous employment with the Service during which he or she must have been regularly engaged in applying and interpreting the provisions of the Internal Revenue Code and the regulations thereunder relating to income, estate, gift, employment, or excise taxes.

(6) For the purposes of paragraph (b)(5) of this section, an aggregate of 10 or more years of employment in positions involving the application and interpretation of the provisions of the Internal Revenue

Code, at least 3 of which occurred within the 5 years preceding the date of application, is the equivalent of 5 years continuous employment.

(c) *Natural persons.* Enrollment to practice may be granted only to natural persons.

§10.5 Application for enrollment.

(a) *Form; address.* An applicant for enrollment must file an application on Form 23, "Application for Enrollment to Practice Before the Internal Revenue Service", properly executed under oath or affirmation, with the Director of Practice. The address of the applicant entered on Form 23 will be the address under which a successful applicant is enrolled and is the address to which the Director will send correspondence concerning enrollment. An enrolled agent must send notification of any change to his or her enrollment address to the Director of Practice, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224, or at such other address specified by the Director. This notification must include the enrolled agent's name, old address, new address, social security number, signature, and the date.

(b) *Fee.* The application for enrollment must be accompanied by a check or money order in the amount set forth on Form 23, payable to the Internal Revenue Service, which amount constitutes a fee charged to each applicant for enrollment. This fee will be retained by the United States whether or not the applicant is granted enrollment.

(c) *Additional information; examination.* The Director of Practice, as a condition to consideration of an application for enrollment, may require the applicant to file additional information and to submit to any written or oral examination under oath or otherwise. The Director will, on written request filed by an applicant, afford such applicant the opportunity to be heard with respect to his or her application for enrollment.

(d) *Temporary recognition.* On receipt of a properly executed application, the Director of Practice may grant the applicant temporary recognition to practice pending a determination as to whether enrollment to practice should be granted. Temporary recognition will be granted only in unusual circumstances

and it will not be granted, in any circumstance, if the application is not regular on its face, if the information stated in the application, if true, is not sufficient to warrant enrollment to practice, or if there is any information before the Director indicating that the statements in the application are untrue or that the applicant would not otherwise qualify for enrollment. Issuance of temporary recognition does not constitute enrollment to practice or a finding of eligibility for enrollment, and the temporary recognition may be withdrawn at any time by the Director.

(e) *Appeal from denial of application.* The Director of Practice must inform the applicant as to the reason(s) for any denial of an application for enrollment. The applicant may, within 30 days after receipt of the notice of denial of enrollment, file a written appeal of the denial of enrollment with the Secretary of the Treasury. A decision on the appeal will be rendered by the Secretary of the Treasury, or his or her designate, as soon as practicable.

§10.6 Enrollment.

(a) *Roster.* The Director of Practice will maintain rosters of all individuals—

(1) Who have been granted active enrollment to practice before the Internal Revenue Service;

(2) Whose enrollment has been placed in inactive status for failure to meet the requirements for renewal of enrollment;

(3) Whose enrollment has been placed in inactive retirement status;

(4) Who have been censured, suspended, or disbarred from practice before the Internal Revenue Service;

(5) Whose offer of consent to resign from enrollment to practice before the Internal Revenue Service has been accepted by the Director of Practice under §10.61 of this part; and

(6) Whose application for enrollment has been denied.

(b) *Enrollment card.* The Director of Practice will issue an enrollment card to each individual whose application for enrollment to practice before the Internal Revenue Service is approved after the effective date of this regulation. Each enrollment card will be valid for the period stated on the enrollment card. Enrollment cards issued to individuals

before February 1, 1999, are invalid. An individual is not eligible to practice before the Service if his or her enrollment card is not valid.

(c) *Term of enrollment.* Each individual enrolled to practice before the Internal Revenue Service will be accorded active enrollment status subject to his or her renewal of enrollment as provided in this part.

(d) *Renewal of enrollment.* To maintain active enrollment to practice before the Internal Revenue Service, each individual enrolled is required to have his or her enrollment renewed. Failure by an individual to receive notification from the Director of Practice of the renewal requirement will not be justification for the failure to satisfy this requirement.

(1) All individuals enrolled to practice before the Internal Revenue Service must apply for renewal of enrollment between November 1, 2001, and January 31, 2002. Those who receive initial enrollment between November 1, 2001, and January 31, 2002, must apply for renewal of enrollment by March 1, 2002. The renewal will be effective April 1, 2002.

(2) Thereafter, applications for renewal will be required between November 1, 2004, and January 31, 2005, and between November 1 and January 31 of every subsequent third year. Those who receive initial enrollment during the renewal application period must apply for renewal of enrollment by March 1 of the renewal year. Renewed enrollment will be effective April 1, 2005, and April 1 of every subsequent third year.

(3) The Director of Practice will notify the individual of his or her renewal of enrollment and will issue the individual a card evidencing renewal.

(4) A reasonable nonrefundable fee may be charged for each application for renewal of enrollment filed with the Director of Practice.

(5) Forms required for renewal may be obtained from the Director of Practice, Internal Revenue Service, Washington, DC 20224.

(e) *Condition for renewal: Continuing professional education.* In order to qualify for renewal of enrollment, an individual enrolled to practice before the Internal Revenue Service must certify, on the application for renewal form prescribed by the Director of Practice, that he or she

has satisfied the following continuing professional education requirements.

(1) *For renewed enrollment effective April 1, 2002.* (i) A minimum of 24 hours of continuing education credit must be completed between January 1, 2001, and January 31, 2002.

(ii) An individual who receives initial enrollment between January 1, 2001, and January 31, 2002, is exempt from the continuing education requirement for the renewal of enrollment effective April 1, 2002, but is required to file a timely application for renewal of enrollment.

(2) *For renewed enrollment effective April 1, 2005, and every third year thereafter.* (i) A minimum of 72 hours of continuing education credit must be completed between February 1, 2002, and January 31, 2005, and during each subsequent three year period. Each such three year period is known as an enrollment cycle.

(ii) A minimum of 16 hours of continuing education credit must be completed in each year of an enrollment cycle.

(iii) An individual who receives initial enrollment during an enrollment cycle must complete two (2) hours of qualifying continuing education credit for each month enrolled during the enrollment cycle. Enrollment for any part of a month is considered enrollment for the entire month.

(f) *Qualifying continuing education—*
(1) *General.* To qualify for continuing education credit, a course of learning must—

(i) Be a qualifying program designed to enhance professional knowledge in Federal taxation or Federal tax related matters, i.e., programs comprised of current subject matter in Federal taxation or Federal tax related matters, including accounting, tax preparation software and taxation; and

(ii) Be conducted by a qualifying sponsor.

(2) *Qualifying programs—*(i) *Formal programs.* A formal program qualifies as continuing education programs if it—

(A) Requires attendance. Additionally, the program sponsor must provide each attendee with a certificate of attendance; and

(B) Requires that the program be conducted by a qualified instructor, discussion leader, or speaker, i.e., a person whose background, training, education

and experience is appropriate for instructing or leading a discussion on the subject matter of the particular program; and

(C) Provides or requires a written outline, textbook, or suitable electronic educational materials.

(ii) *Correspondence or individual study programs (including taped programs).* Qualifying continuing education programs include correspondence or individual study programs that are conducted by qualifying sponsors and completed on an individual basis by the enrolled individual. The allowable credit hours for such programs will be measured on a basis comparable to the measurement of a seminar or course for credit in an accredited educational institution. Such programs qualify as continuing education programs if they—

(A) Require registration of the participants by the sponsor;

(B) Provide a means for measuring completion by the participants (e.g., a written examination), including the issuance of a certificate of completion by the sponsor; and

(C) Provide a written outline, textbook, or suitable electronic educational materials.

(iii) *Serving as an instructor, discussion leader or speaker.* (A) One hour of continuing education credit will be awarded for each contact hour completed as an instructor, discussion leader, or speaker at an educational program that meets the continuing education requirements of paragraph (f) of this section.

(B) Two hours of continuing education credit will be awarded for actual subject preparation time for each contact hour completed as an instructor, discussion leader, or speaker at such programs. It is the responsibility of the individual claiming such credit to maintain records to verify preparation time.

(C) The maximum credit for instruction and preparation may not exceed 50 percent of the continuing education requirement for an enrollment cycle.

(D) An instructor, discussion leader, or speaker who makes more than one presentation on the same subject matter during an enrollment cycle, will receive continuing education credit for only one such presentation for the enrollment cycle.

(iv) *Credit for published articles, books, etc.* (A) Continuing education

credit will be awarded for publications on Federal taxation or Federal tax related matters, including accounting, financial management, tax preparation software, and taxation, provided the content of such publications is current and designed for the enhancement of the professional knowledge of an individual enrolled to practice before the Internal Revenue Service.

(B) The credit allowed will be on the basis of one hour credit for each hour of preparation time for the material. It is the responsibility of the person claiming the credit to maintain records to verify preparation time.

(C) The maximum credit for publications may not exceed 25 percent of the continuing education requirement of any enrollment cycle.

(3) *Periodic examination.* (i) Individuals may establish eligibility for renewal of enrollment for any enrollment cycle by—

(A) Achieving a passing score on each part of the Special Enrollment Examination administered under this part during the three year period prior to renewal; and

(B) Completing a minimum of 16 hours of qualifying continuing education during the last year of an enrollment cycle.

(ii) Courses designed to help an applicant prepare for the examination specified in paragraph (a) of §10.4 are considered basic in nature and are not qualifying continuing education.

(g) *Sponsors.* (1) Sponsors are those responsible for presenting programs.

(2) To qualify as a sponsor, a program presenter must—

(i) Be an accredited educational institution;

(ii) Be recognized for continuing education purposes by the licensing body of any State, possession, territory, Commonwealth, or the District of Columbia responsible for the issuance of a license in the field of accounting or law;

(iii) Be recognized by the Director of Practice as a professional organization or society whose programs include offering continuing professional education opportunities in subject matters within the scope of paragraph (f)(1)(i) of this section; or

(iv) File a sponsor agreement with the Director of Practice and obtain approval of the program as a qualified continuing education program.

(3) A qualifying sponsor must ensure the program complies with the following requirements—

(i) Programs must be developed by individual(s) qualified in the subject matter;

(ii) Program subject matter must be current;

(iii) Instructors, discussion leaders, and speakers must be qualified with respect to program content;

(iv) Programs must include some means for evaluation of technical content and presentation;

(v) Certificates of completion must be provided those who have successfully completed the program; and

(vi) Records must be maintained by the sponsor to verify the participants who attended and completed the program for a period of three years following completion of the program. In the case of continuous conferences, conventions, and the like, records must be maintained to verify completion of the program and attendance by each participant at each segment of the program.

(4) Professional organizations or societies wishing to be considered as qualified sponsors must request this status from the Director of Practice and furnish information in support of the request together with any further information deemed necessary by the Director.

(5) A professional organization or society recognized as a qualified sponsor by the Director of Practice will retain its status for one enrollment cycle. The Director will publish the names of such sponsors on a periodic basis.

(h) *Measurement of continuing education coursework.* (1) All continuing education programs will be measured in terms of contact hours. The shortest recognized program will be one contact hour.

(2) A contact hour is 50 minutes of continuous participation in a program. Credit is granted only for a full contact hour, i.e., 50 minutes or multiples thereof. For example, a program lasting more than 50 minutes but less than 100 minutes will count as one contact hour.

(3) Individual segments at continuous conferences, conventions and the like will be considered one total program. For example, two 90-minute segments (180 minutes) at a continuous conference will count as three contact hours.

(4) For university or college courses, each semester hour credit will equal 15 contact hours and a quarter hour credit will equal 10 contact hours.

(i) *Recordkeeping requirements.* (1) Each individual applying for renewal must retain for a period of three years following the date of renewal of enrollment the information required with regard to qualifying continuing professional education credit hours. Such information includes—

(i) The name of the sponsoring organization;

(ii) The location of the program;

(iii) The title of the program and description of its content;

(iv) Written outlines, course syllabi, textbook, and/or electronic materials provided or required for the course;

(v) The dates attended;

(vi) The credit hours claimed;

(vii) The name(s) of the instructor(s), discussion leader(s), or speaker(s), if appropriate; and

(viii) The certificate of completion and/or signed statement of the hours of attendance obtained from the sponsor.

(2) To receive continuing education credit for service completed as an

instructor, discussion leader, or speaker, the following information must be maintained for a period of three years following the date of renewal of enrollment—

(i) The name of the sponsoring organization;

(ii) The location of the program;

(iii) The title of the program and description of its content;

(iv) The dates of the program; and

(v) The credit hours claimed.

(3) To receive continuing education credit for publications, the following information must be maintained for a period of three years following the date of renewal of enrollment—

(i) The publisher;

(ii) The title of the publication;

(iii) A copy of the publication;

(iv) The date of publication; and

(v) Records that substantiate the hours worked on the publication.

(j) *Waivers.* (1) Waiver from the continuing education requirements for a given period may be granted by the Director of Practice for the following reasons—

(i) Health, which prevented compliance with the continuing education requirements;

(ii) Extended active military duty;

(iii) Absence from the United States for an extended period of time due to employment or other reasons, provided the individual does not practice before the Internal Revenue Service during such absence; and

(iv) Other compelling reasons, which will be considered on a case-by-case basis.

(2) A request for waiver must be accompanied by appropriate documentation. The individual is required to furnish any additional documentation or explanation deemed necessary by the Director of Practice. Examples of appropriate documentation could be a medical certificate or military orders.

(3) A request for waiver must be filed no later than the last day of the renewal application period.

(4) If a request for waiver is not approved, the individual will be placed in inactive status, so notified by the Director of Practice, and placed on a roster of inactive enrolled individuals.

(5) If a request for waiver is approved, the individual will be notified and issued a card evidencing renewal.

(6) Those who are granted waivers are required to file timely applications for renewal of enrollment.

(k) *Failure to comply.* (1) Compliance by an individual with the requirements of this part is determined by the Director of Practice. An individual who fails to meet the requirements of eligibility for renewal of enrollment will be notified by the Director at his or her enrollment address by first class mail. The notice will state the basis for the determination of non-compliance and will provide the individual an opportunity to furnish information in writing relating to the matter within 60 days of the date of the notice. Such information will be considered by the Director in making a final determination as to eligibility for renewal of enrollment.

(2) The Director of Practice may require any individual, by notice sent by first class mail to his or her enrollment address, to provide copies of any records required to be maintained under this part. The Director may disallow any continuing professional education hours claimed if

the individual fails to comply with this requirement.

(3) An individual who has not filed a timely application for renewal of enrollment, who has not made a timely response to the notice of noncompliance with the renewal requirements, or who has not satisfied the requirements of eligibility for renewal will be placed on a roster of inactive enrolled individuals. During this time, the individual will be ineligible to practice before the Internal Revenue Service.

(4) Individuals placed in inactive enrollment status and individuals ineligible to practice before the Internal Revenue Service may not, directly or indirectly, indicate that they are enrolled to practice before the Service, or use the term "enrolled agent," the designation "E. A.," or other form of reference to eligibility to practice before the Service.

(5) An individual placed in an inactive status may be reinstated to an active enrollment status by filing an application for renewal of enrollment and providing evidence of the completion of the all required continuing professional education hours for the enrollment cycle. Continuing education credit under this subsection may not be used to satisfy the requirements of the enrollment cycle in which the individual has been placed back on the active roster.

(6) An individual placed in an inactive status must file an application for renewal of enrollment and satisfy the requirements for renewal as set forth in this section within three years of being placed in an inactive status. The name of such individual otherwise will be removed from the inactive enrollment roster and his or her enrollment will terminate. Eligibility for enrollment must then be reestablished by the individual as provided in this section.

(7) Inactive enrollment status is not available to an individual who is the subject of a disciplinary matter in the Office of Director of Practice.

(l) *Inactive retirement status.* An individual who no longer practices before the Internal Revenue Service may request being placed in an inactive status at any time and such individual will be placed in an inactive retirement status. The individual will be ineligible to practice before the Service. Such individual must file a time-

ly application for renewal of enrollment at each applicable renewal or enrollment period as provided in this section. An individual who is placed in an inactive retirement status may be reinstated to an active enrollment status by filing an application for renewal of enrollment and providing evidence of the completion of the required continuing professional education hours for the enrollment cycle. Inactive retirement status is not available to an individual who is subject of a disciplinary matter in the Office of Director of Practice.

(m) *Renewal while under suspension or disbarment.* An individual who is ineligible to practice before the Internal Revenue Service by virtue of disciplinary action is required to be in conformance with the requirements for renewal of enrollment before his or her eligibility is restored.

(n) *Verification.* The Director of Practice may review the continuing education records of an enrolled individual and/or qualified sponsor in a manner deemed appropriate to determine compliance with the requirements and standards for renewal of enrollment as provided in paragraph (f) of this section.

(o) *Enrolled Actuaries.* The enrollment and the renewal of enrollment of actuaries authorized to practice under paragraph (d) of §10.3 are governed by the regulations of the Joint Board for the Enrollment of Actuaries at 20 CFR 901.1 *et seq.*

§10.7 Representing oneself; participating in rulemaking; limited practice; special appearances; and return preparation.

(a) *Representing oneself.* Individuals may appear on their own behalf before the Internal Revenue Service provided they present satisfactory identification.

(b) *Participating in rulemaking.* Individuals may participate in rulemaking as provided by the Administrative Procedure Act. See 5 U.S.C. 553.

(c) *Limited practice*—(1) *In general.* Subject to the limitations in paragraph (c)(2) of this section, an individual who is not a practitioner may represent a taxpayer before the Internal Revenue Service in the circumstances described in this paragraph (c)(1), even if the taxpayer is not present, provided the individual presents satisfactory identification and proof of his or her authority to represent the taxpayer.

The circumstances described in this paragraph (c)(1) are as follows:

(i) An individual may represent a member of his or her immediate family.

(ii) A regular full-time employee of an individual employer may represent the employer.

(iii) A general partner or a regular full-time employee of a partnership may represent the partnership.

(iv) A *bona fide* officer or a regular full-time employee of a corporation (including a parent, subsidiary, or other affiliated corporation), association, or organized group may represent the corporation, association, or organized group.

(v) A regular full-time employee of a trust, receivership, guardianship, or estate may represent the trust, receivership, guardianship, or estate.

(vi) An officer or a regular employee of a governmental unit, agency, or authority may represent the governmental unit, agency, or authority in the course of his or her official duties.

(vii) An individual may represent any individual or entity, who is outside the United States, before personnel of the Internal Revenue Service when such representation takes place outside the United States.

(viii) An individual who prepares and signs a taxpayer's tax return as the preparer, or who prepares a tax return but is not required (by the instructions to the tax return or regulations) to sign the tax return, may represent the taxpayer before revenue agents, customer service representatives or similar officers and employees of the Internal Revenue Service during an examination of the taxable year or period covered by that tax return, but this right does not permit such individual to represent the taxpayer, regardless of the circumstances requiring representation, before appeals officers, revenue officers, Counsel or similar officers or employees of the Service or the Department of Treasury.

(2) *Limitations.* (i) An individual who is under suspension or disbarment from practice before the Internal Revenue Service may not engage in limited practice before the Service under paragraph (c)(1) of this section.

(ii) The Director, after notice and opportunity for a conference, may deny eligibility to engage in limited practice

before the Internal Revenue Service under paragraph (c)(1) of this section to any individual who has engaged in conduct that would justify censuring, suspending, or disbaring a practitioner from practice before the Service.

(iii) An individual who represents a taxpayer under the authority of paragraph (c)(1) of this section is subject, to the extent of his or her authority, to such rules of general applicability regarding standards of conduct and other matters as the Director of Practice prescribes.

(d) *Special appearances.* The Director of Practice may, subject to such conditions as he or she deems appropriate, authorize an individual who is not otherwise eligible to practice before the Service to represent another person in a particular matter.

(e) *Preparing tax returns and furnishing information.* Any individual may prepare a tax return, appear as a witness for the taxpayer before the Internal Revenue Service, or furnish information at the request of the Service or any of its officers or employees.

(f) *Fiduciaries.* For purposes of this part, a fiduciary (i.e., a trustee, receiver, guardian, personal representative, administrator, or executor) is considered to be the taxpayer and not a representative of the taxpayer.

§10.8 Customhouse brokers.

Nothing contained in the regulations in this part will affect or limit the right of a customhouse broker, licensed as such by the Commissioner of Customs in accordance with the regulations prescribed therefor, in any customs district in which he or she is so licensed, at the local office of the Internal Revenue Service or before the National Office of the Service, to act as a representative in respect to any matters relating specifically to the importation or exportation of merchandise under the customs or internal revenue laws, for any person for whom he or she has acted as a customhouse broker.

Subpart B — Duties and Restrictions Relating to Practice Before the Internal Revenue Service

§10.20 Information to be furnished.

(a) *To the Internal Revenue Service.* A practitioner must, on a proper and lawful

request by a duly authorized officer or employee of the Internal Revenue Service, promptly submit records or information in any matter before the Internal Revenue Service unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged. Where the requested records or information are not in the possession or control of the practitioner or the practitioner's client, the practitioner must promptly notify the requesting officer or employee, and must provide any information that either the practitioner or the practitioner's client has regarding the identity of any person who may have possession or control of the requested records or information. A practitioner may not interfere, or attempt to interfere, with any proper and lawful effort by the Service or its officers or employees to obtain any record or information unless the practitioner believes in good faith and on reasonable grounds that the record or information is privileged.

(b) *To the Director of Practice.* When a proper and lawful request is made by the Director of Practice, a practitioner must provide the Director with any information the practitioner has concerning a violation or possible violation of the regulations in this part by any person, and to testify regarding this information in any proceeding instituted under this part, unless the practitioner believes in good faith and on reasonable grounds that the information is privileged.

§10.21 Knowledge of client's omission.

A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such non-compliance, error, or omission, the manner in which corrective action may be taken, and the possible consequences of not taking corrective action.

§10.22 Diligence as to accuracy.

(a) *In general.* A practitioner must exercise due diligence—

(1) In preparing or assisting in the preparation of, approving, and filing tax

returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

(2) In determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and

(3) In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.

(b) *Reliance on others.* Except as provided in §§10.33, 10.34, and 10.35, a practitioner will be presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.

§10.23 Prompt disposition of pending matters.

A practitioner may not unreasonably delay the prompt disposition of any matter before the Internal Revenue Service.

§10.24 Assistance from or to disbarred or suspended persons and former Internal Revenue Service employees.

A practitioner may not, knowingly and directly or indirectly:

(a) Accept assistance from or assist any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter or matters constituting practice before the Service.

(b) Accept assistance from any former government employee where the provisions of §10.25 of this part or any Federal law would be violated.

§10.25 Practice by former Government employees, their partners and their associates.

(a) *Definitions.* For purposes of this section—

(1) *Assist* means to act in such a way as to advise, furnish information to, or otherwise aid another person, directly or indirectly.

(2) *Government employee* is an officer or employee of the United States or any

agency of the United States, including a *special government employee* as defined in 18 U.S.C. 202(a), or of the District of Columbia, or of any State, or a member of Congress or of any State legislature.

(3) *Member of a firm* is a sole practitioner or an employee or associate thereof, or a partner, stockholder, associate, affiliate or employee of a partnership, joint venture, corporation, professional association or other affiliation of two or more practitioners who represent nongovernmental parties.

(4) *Practitioner* includes any individual described in paragraph (f) of §10.2.

(5) *Official responsibility* means the direct administrative or operating authority, whether intermediate or final, and either exercisable alone or with others, and either personally or through subordinates, to approve, disapprove, or otherwise direct Government action, with or without knowledge of the action.

(6) *Participate or participation* means substantial involvement as a Government employee by making decisions, or preparing or reviewing documents with or without the right to exercise a judgment of approval or disapproval, or participating in conferences or investigations, or rendering advice of a substantial nature.

(7) *Rule* includes Treasury Regulations, whether issued or under preparation for issuance as Notices of Proposed Rule Making or as Treasury Decisions; revenue rulings; and revenue procedures published in the Internal Revenue Bulletin. *Rule* does not include a *transaction* as defined in paragraph (a)(8) of this section.

(8) *Transaction* means any decision, determination, finding, letter ruling, technical advice, Chief Counsel advice, or contract or the approval or disapproval thereof, relating to a particular factual situation or situations involving a specific party or parties whose rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service, or other legal rights, are determined or immediately affected therein and to which the United States is a party or in which it has a direct and substantial interest, whether or not the same taxable periods are involved. *Transaction* does not include *rule* as defined in paragraph (a)(7) of this section.

(b) *General rules.* (1) No former Government employee may, subsequent

to his or her Government employment, represent anyone in any matter administered by the Internal Revenue Service if the representation would violate 18 U.S.C. 207 or any other laws of the United States.

(2) No former Government employee who participated in a transaction may, subsequent to his or her Government employment, represent or knowingly assist, in that transaction, any person who is or was a specific party to that transaction.

(3) A former Government employee who within a period of one year prior to the termination of Government employment had official responsibility for a transaction may not, within two years after his or her Government employment is ended, represent or knowingly assist in that transaction any person who is or was a specific party to that transaction.

(4) No former Government employee may, within one year after his or her Government employment is ended, appear before any employee of the Treasury Department in connection with the publication, withdrawal, amendment, modification, or interpretation of a rule in the development of which the former Government employee participated or for which, within a period of one year prior to the termination of his or her Government employment, he or she had official responsibility. This paragraph (b)(4) does not, however, preclude such former employee from appearing on his or her own behalf or from representing a taxpayer before the Internal Revenue Service in connection with a transaction involving the application or interpretation of such a rule with respect to that transaction, provided that such former employee does not utilize or disclose any confidential information acquired by the former employee in the development of the rule.

(c) *Firm representation.* (1) No member of a firm of which a former Government employee is a member may represent or knowingly assist a person who was or is a specific party in any transaction with respect to which the restrictions of paragraph (b)(2) or (3) of this section apply to the former Government employee, in that transaction, unless the firm isolates the former Government employee in such a way to ensure that the former Government employee cannot assist in the representation.

(2) When isolation of a former Government employee is required under paragraph (c)(1) of this section, a statement affirming the fact of such isolation must be executed under oath by the former Government employee and by another member of the firm acting on behalf of the firm. The statement must clearly identify the firm, the former Government employee, and the transaction(s) requiring isolation and it must be filed with the Director of Practice and in such other place and in the manner prescribed by rule or regulation.

(d) *Pending representation.* Practice by former Government employees, their partners and associates with respect to representation in specific matters where actual representation commenced before adoption of this regulation is governed by the regulations set forth at 31 CFR Part 10 immediately preceding the adoption of these regulations. The burden of showing that representation commenced before adoption of the revised regulations lies with the former Government employees, and their partners and associates.

§10.26 Notaries.

A practitioner may not take acknowledgments, administer oaths, certify papers, or perform any official act as a notary public with respect to any matter administered by the Internal Revenue Service and for which he or she is employed as counsel, attorney, or agent, or in which he or she may be in any way interested. (26 Op. Atty. Gen. 236).

§10.27 Fees.

(a) *Generally.* A practitioner may not charge an unconscionable fee for representing a client in a matter before the Internal Revenue Service.

(b) *Contingent fees.* A practitioner may not charge a contingent fee for preparing an original tax return or for any advice rendered in connection with a position taken or to be taken on an original tax return. A practitioner may charge a contingent fee for preparing, or for any advice rendered in connection with a position taken or to be taken on, an amended tax return or a claim for refund (other than a claim for refund made on an original tax return) if the practitioner reasonably anticipates at the time the fee arrangement

is entered into that the amended tax return or refund claim will receive substantive review by the Internal Revenue Service. For purposes of this section, a contingent fee is any fee that is based, in whole or in part, on whether or not a position taken on a tax return or in a refund claim is sustained by the Service or in litigation. A contingent fee includes an indemnity agreement, a guarantee, rescission rights, insurance, or any other arrangement under which the taxpayer or other person would be entitled to be compensated or reimbursed by the practitioner in the event a position taken on a tax return or in a refund claim is not sustained, or any other arrangement that has a similar effect.

§10.28 Return of client's records.

On the request of a client, a practitioner must promptly return any and all records of the client. The existence of a dispute over fees does not relieve the practitioner of his or her responsibility under this section. The practitioner may retain copies of the records returned to a client.

§10.29 Conflicting interests.

(a) A practitioner may not represent potential conflicting interests in his or her practice before the Internal Revenue Service, unless—

(1) The practitioner reasonably believes that the representation of any party before the Service will not be adversely affected; and

(2) All parties represented by the practitioner who have an interest in the matter before the Service expressly consent in writing to the representation after the practitioner has fully disclosed the potential conflict.

(b) Copies of the written consents must be retained by the practitioner for at least 36 months from the date of the conclusion of the representation of the affected clients and the written consents must be provided to any officer or employee of the Internal Revenue Service on request.

(c) A practitioner may not represent a party in his or her practice before the Internal Revenue Service if the representation of the party may be materially limited by the practitioner's own interests, unless the practitioner reasonably believes the representation will not be adversely

affected and the client consents after the practitioner has fully disclosed the potential conflict, including disclosure of the implications of the potential conflict and the risks involved.

§10.30 Solicitation.

(a) *Advertising and solicitation restrictions.* (1) A practitioner may not, with respect to any Internal Revenue Service matter, in any way use or participate in the use of any form of public communication or private solicitation containing a false, fraudulent, or coercive statement or claim; or a misleading or deceptive statement or claim. Enrolled agents, in describing their professional designation, may not utilize the term of art "certified" or "licensed" or indicate an employer/employee relationship with the Service. Examples of acceptable descriptions are "enrolled to represent taxpayers before the Internal Revenue Service," "enrolled to practice before the Internal Revenue Service," and "admitted to practice before the Internal Revenue Service." Enrolled agents and enrolled actuaries may abbreviate such designation as either EA or E.A. Examples of unacceptable descriptions are "Internal Revenue Service (or IRS) Enrolled Agent," "Enrolled Agent of the Internal Revenue Service (or IRS)," "Certified Enrolled Agent," or "Licensed to practice before the Internal Revenue Service (or IRS)."

(2) A practitioner may not make, directly or indirectly, an uninvited written or oral solicitation of employment in matters related to the Internal Revenue Service if the solicitation violates Federal or State law or other applicable rule, e.g., attorneys are precluded from making a solicitation that is prohibited by the rules of the State bar to which they are members. Any lawful solicitation made by or on behalf of a practitioner eligible to practice before the Service must, nevertheless, clearly identify the solicitation as such and, if applicable, identify the source of the information used in choosing the recipient.

(b) *Fee information.* (1)(i) A practitioner may publish the availability of a written schedule of fees and disseminate the following fee information—

(A) Fixed fees for specific routine services.

(B) Hourly rates.

(C) Range of fees for particular services.

(D) Fee charged for an initial consultation.

(ii) Any statement of fee information concerning matters in which costs may be incurred must include a statement disclosing whether clients will be responsible for such costs.

(2) A practitioner may charge no more than the rate(s) published under paragraph (b)(1) of this section for a reasonable period of time after the last date on which the schedule of fees was published (which, in no event, may be shorter than 30 days).

(c) *Communication of fee information.* Fee information may be communicated in professional lists, telephone directories, print media, mailings, electronic mail, facsimile, hand delivered flyers, radio, television, and any other method. The method chosen, however, must not cause the communication to become untruthful, deceptive, or otherwise in violation of these regulations. A practitioner may not persist in attempting to contact a prospective client if the prospective client has made it known to the practitioner that he or she does not desire to be solicited. In the case of radio and television broadcasting, the broadcast must be recorded and the practitioner must retain a recording of the actual transmission. In the case of direct mail and e-commerce communications, the practitioner must retain a copy of the actual communication, along with a list or other description of persons to whom the communication was mailed or otherwise distributed. The copy must be retained by the practitioner for a period of at least 36 months from the date of the last transmission or use.

(d) *Improper associations.* A practitioner may not, in matters related to the Internal Revenue Service, assist, or accept assistance from, any person or entity who, to the knowledge of the practitioner, obtains clients or otherwise practices in a manner forbidden under this section.

§10.31 Negotiation of taxpayer checks.

A practitioner who prepares tax returns may not endorse or otherwise negotiate any check issued to a client by the government in respect of a Federal tax liability.

§10.32 Practice of law.

Nothing in the regulations in this part may be construed as authorizing persons not members of the bar to practice law.

§10.33 Tax shelter opinions used by third parties to market tax shelters.

(a) *In general.* A practitioner who provides a tax shelter opinion that does not conclude that the Federal tax treatment of a tax shelter item or items is more likely than not the proper treatment must comply with each of the following requirements with respect to each such item.

(1) *Factual matters.* (i) The practitioner must make inquiry as to all relevant facts, be satisfied that the opinion takes account of all relevant facts, and be satisfied that the material facts (including factual assumptions and representations) are accurately and completely described in the opinion and in any related offering materials or sales promotion materials.

(ii) The opinion must not be based, directly or indirectly, on any unreasonable factual assumptions (including assumptions as to future events). Unreasonable factual assumptions include—

(A) A factual assumption that the practitioner knows or has reason to believe is incorrect, incomplete, inconsistent with an important fact or another factual assumption, or implausible in any material respect; or

(B) A factual assumption regarding a fact or facts that the practitioner could reasonably request to be provided or to be represented.

(iii) A practitioner may, where it would be reasonable based on all the facts and circumstances, rely upon factual representations, statements, findings, or agreements (factual representations) (including representations describing the specific business reasons for the transaction, the potential profitability of the transaction apart from tax benefits, or a valuation prepared by an independent party). Factors relevant to whether such factual representations are reasonable include, but are not limited to, whether the person making the factual representations is knowledgeable as to the facts being represented and is the appropriate person to make such factual representations. A practitioner does not need to conduct an audit or independent verification of a factual representation,

but the practitioner may not rely on factual representations if the practitioner knows or has reason to believe, based on his or her background and knowledge, that the relevant information is, or otherwise appears to be, unreasonable, incorrect, incomplete, inconsistent with an important fact or another factual representation, or implausible in any material respect. For example, a representation is incomplete if it states that there are business reasons for the transaction without describing those reasons, or if it states that a transaction is potentially profitable apart from tax benefits without providing adequate factual support. In addition, a valuation is inconsistent with an important fact or factual assumption or is implausible if it appears to be based on facts that are inconsistent with the facts of the transaction.

(iv) If the fair market value of property or the expected financial performance of an investment is relevant to the tax shelter item, a practitioner may not accept an appraisal or financial projection as support for the matters claimed therein unless—

(A) The appraisal or financial projection makes sense on its face;

(B) The practitioner reasonably believes that the person making the appraisal or financial projection is reputable and competent to perform the appraisal or projection; and

(C) The appraisal is based on the definition of fair market value prescribed under the relevant Federal tax provisions.

(v) If the fair market value of purchased property is to be established by reference to its stated purchase price, the practitioner must examine the terms and conditions on which the property was (or is to be) purchased to determine whether the stated purchase price reasonably may be considered to be its fair market value.

(2) *Relate law to facts.* (i) The opinion must relate the applicable law to the relevant facts.

(ii) The opinion must clearly identify the facts upon which the opinion's conclusions are based.

(iii) The opinion must contain a reasoned analysis of the pertinent facts and legal authorities and must not assume the favorable resolution of any Federal tax issue material to the analysis or otherwise rely on any unreasonable legal assumptions.

(iv) The opinion must not contain legal analyses or conclusions with respect to Federal tax issues that are inconsistent with each other.

(3) *Analysis of material Federal tax issues.* The practitioner must ascertain that all material Federal tax issues have been considered, and that all of those issues that involve the reasonable possibility of a challenge by the Internal Revenue Service have been fully and fairly addressed. The opinion must state that the practitioner has considered the possible application to the facts of all potentially relevant judicial doctrines, including the step transaction, business purpose, economic substance, substance over form, and sham transaction doctrines, as well as potentially relevant statutory and regulatory anti-abuse rules, and the opinion must analyze whether the tax shelter item is vulnerable to challenge under all potentially relevant doctrines and anti-abuse rules. In analyzing such judicial doctrines and statutory and regulatory anti-abuse rules, the opinion must take into account the typical investor's non-tax and tax purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner.

(4) *Evaluation of material Federal tax issues.* The practitioner must, where possible, clearly provide his or her conclusion as to the likelihood that a typical investor of the type to whom the tax shelter is or will be marketed will prevail on the merits with respect to each material Federal tax issue that involves the reasonable possibility of a challenge by the Internal Revenue Service. If the practitioner is unable to reach such a conclusion with respect to one or more Federal tax issues, he or she must clearly state that he or she is unable to reach such a conclusion with respect to those issues. The practitioner's opinion must fully describe the reasons for the practitioner's conclusions or fully describe the reasons for his or her inability to reach a conclusion as to one or more issues.

(5) *Overall conclusion.* (i) The practitioner must, where possible, clearly provide an overall conclusion as to the likelihood that the Federal tax treatment of the tax shelter item or items is the proper treatment. If the practitioner is unable to reach such an overall conclusion, he or

she must clearly state that he or she is unable to reach such an overall conclusion and the opinion must fully describe the reasons for the practitioner's inability to reach a conclusion.

(ii) The fact that the practitioner's opinion does not reach an overall conclusion that the Federal tax treatment of the tax shelter item or items is more likely than not the proper treatment, or the fact that the practitioner is unable to reach an overall conclusion, must be clearly and prominently disclosed on the first page of the opinion.

(iii) The opinion must clearly and prominently disclose on the first page of the opinion that the opinion was not written for the purpose of establishing—

(A) Under section 6662(d)(2)(C)(i)(II) of the Internal Revenue Code and 26 CFR 1.6662-4(g)(4), that a taxpayer other than a corporation reasonably believed at the time a tax return was filed that the tax treatment of a tax shelter item was more likely than not the proper treatment of that item; or

(B) Under section 6664(c)(1) of the Internal Revenue Code and 26 CFR 1.6664-4(e), that a corporate taxpayer acted with reasonable cause and in good faith with respect to a tax shelter item.

(iv) In ascertaining that all material Federal tax issues have been considered, evaluating the merits of those issues and evaluating whether the Federal tax treatment of the tax shelter item or items is the proper treatment, the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.

(6) *Description of opinion.* The practitioner must take reasonable steps to assure that any written materials or promotional efforts that distribute, reflect or refer to the tax shelter opinion, correctly and fairly represent the nature and extent of the opinion.

(b) *Competence to provide opinion; reliance on opinions of others.* (1) The practitioner must be knowledgeable in all of the aspects of Federal tax law relevant to the opinion being rendered.

(i) A practitioner may not provide a tax shelter opinion that does not clearly provide his or her conclusion as to the likelihood that a typical investor of the type to whom the tax shelter is or will be market-

ed will prevail on the merits with respect to each material Federal tax issue that involves the reasonable possibility of a challenge by the Internal Revenue Service (or, alternatively, if the practitioner is unable to reach a conclusion with respect to one or more material Federal tax issues, an opinion that does not clearly state that he or she is unable to reach a conclusion with respect to those issues), or does not provide an overall conclusion as to the likelihood that the Federal tax treatment of the tax shelter item or items is the proper treatment (or, alternatively, if the practitioner is unable to reach an overall conclusion, an opinion that does not clearly state that he or she is unable to reach such an overall conclusion), unless—

(A) At least one other competent practitioner provides an opinion on the likely outcome with respect to all of the other material Federal tax issues which involve a reasonable possibility of challenge by the Internal Revenue Service, and with respect to the tax shelter item or items; and

(B) The practitioner, on reviewing such other opinions and any written materials that distribute, reflect or refer to such other opinions, has no reason to believe that the other practitioner did not comply with the standards of paragraph (a) of this section.

(ii) Notwithstanding the foregoing, a practitioner who has not been retained to provide an overall evaluation may issue an opinion on less than all the material tax issues only if he or she has no reason to believe, based on his or her knowledge and experience, that an overall conclusion given by the practitioner who reaches an overall conclusion is incorrect on its face. Such practitioner also must ensure that the limited opinion satisfies the requirements of this section that are otherwise applicable.

(2) *Financial forecasts and projections.* A practitioner who makes financial forecasts or projections relating to or based on the tax consequences of the tax shelter item that are included in written materials disseminated to any or all of the same persons as the opinion may rely on the opinion of another practitioner as to any or all material Federal tax issues, provided that the practitioner who desires to rely on the other opinion has no reason to believe the

practitioner rendering such other opinion has not complied with the standards of paragraph (a) of this §10.33, and the requirements of paragraphs (b)(1)(i)(A) and (B) and the first sentence of paragraph (b)(1)(ii) of this section are satisfied. The practitioner's report must disclose any material Federal tax issue not covered by, or incorrectly opined on, by the other opinion, and shall set forth his or her opinion with respect to each such issue in a manner that satisfies the requirements of paragraph (a) of this section.

(c) *Definitions.* For purposes of this section—

(1) *Practitioner* includes any individual described in paragraph (f) of §10.2.

(2) The definition of *tax shelter* is set forth in section 6662(d)(2)(C)(iii) of the Internal Revenue Code.

(3) A *tax shelter item* is an item of income, gain, loss, deduction or credit if the item is directly or indirectly attributable to a tax shelter as defined in section 6662(d)(2)(C)(iii) of the Internal Revenue Code.

(4) A *tax shelter opinion*, as the term is used in this section, is written advice by a practitioner concerning the Federal tax aspects of a tax shelter item or items that a practitioner knows or has reason to believe will be used or referred to by a person other than the practitioner (or person who is a member of, associated with, or employed by the practitioner's firm or company) in promoting, marketing or recommending the tax shelter to one or more taxpayers, irrespective of whether such promotional, marketing, or similar activities are conducted privately or publicly. The term *tax shelter opinion* includes the Federal tax aspects or tax risks portion of offering materials prepared for the person who is promoting, marketing or recommending the tax shelter by or at the direction of a practitioner, whether or not a separate opinion letter is issued or whether or not the practitioner's name is referred to in offering materials or in connection with sales promotion efforts. Similarly, a financial forecast or projection prepared by a practitioner is a *tax shelter opinion* if it is predicated on assumptions regarding Federal tax aspects of the investment and that meets the other requirements of the first sentence of this paragraph. The term *tax shelter opinion* does not include

advice provided in connection with the review of portions of offering or sales promotion materials, provided neither the name of the practitioner or the practitioner's firm, nor the fact that a practitioner has rendered advice concerning the Federal tax aspects, is referred to in the offering materials or related sales promotion efforts.

(5) A *material Federal tax issue*, as the term is used in this section, is any Federal tax issue the resolution of which could have a significant impact (whether beneficial or adverse) on a taxpayer under any reasonably foreseeable circumstance. A material Federal tax issue includes the potential applicability of penalties, additions to tax, or interest charges that reasonably could be asserted by the Internal Revenue Service with respect to the tax shelter item.

(6) The following examples illustrate this section—

Example 1. A practitioner is requested by a third party to prepare a memorandum evaluating whether the purported Federal tax treatment of a tax shelter item arising from a series of transactions will be sustained if challenged by the Internal Revenue Service. The practitioner concludes that there is a realistic possibility that the purported treatment of the tax shelter item is the proper treatment and has reason to believe that the third party will use or refer to the memorandum he prepares in promoting, marketing or recommending the transaction to one or more taxpayers. The memorandum is a tax shelter opinion for purposes of this section.

Example 2. A practitioner writes a memorandum that evaluates whether a hypothetical taxpayer which enters into a series of transactions can offset a pre-existing capital gain against certain losses arising from the series of transactions. The practitioner concludes that, while a significant purpose for entering into the series of transactions is the avoidance or evasion of Federal income tax within the meaning of section 6662(d)(2)(C)(iii) of the Internal Revenue Code, there is a realistic possibility that the tax loss arising from this series of transactions is the proper treatment. The practitioner plans to provide this memorandum directly to clients who have capital gains. The memorandum is not a tax shelter opinion for purposes of this section because the promoting, marketing or recommending of the tax shelter is not being done by a person other than the practitioner.

§10.34 Standards for advising with respect to tax return positions and for preparing or signing returns.

(a) *Realistic possibility standard.* A practitioner may not sign a tax return as a preparer if the practitioner determines that the tax return contains a position that does not have a realistic possibility of being sustained on its merits (the realistic possi-

bility standard) unless the position is not frivolous and is adequately disclosed to the Internal Revenue Service. A practitioner may not advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position is taken, unless—

(1) The practitioner determines that the position satisfies the realistic possibility standard; or

(2) The position is not frivolous and the practitioner advises the client of any opportunity to avoid the accuracy-related penalty in section 6662 of the Internal Revenue Code by adequately disclosing the position and of the requirements for adequate disclosure.

(b) *Advising clients on potential penalties.* A practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, must inform the client of the penalties reasonably likely to apply to the client with respect to the position advised, prepared, or reported. The practitioner also must inform the client of any opportunity to avoid any such penalty by disclosure, if relevant, and of the requirements for adequate disclosure. This paragraph (b) applies even if the practitioner is not subject to a penalty with respect to the position.

(c) *Relying on information furnished by clients.* A practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

(d) *Definitions.* For purposes of this section—

(1) *Realistic possibility.* A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits. The authorities described in 26 CFR 1.6662-4(d)(3)(iii),

or any successor provision, of the substantial understatement penalty regulations may be taken into account for purposes of this analysis. The possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.

(2) *Frivolous.* A position is frivolous if it is patently improper.

§10.35 More likely than not tax shelter opinions.

(a) *In general.* A practitioner who provides a tax shelter opinion that concludes that the Federal tax treatment of a tax shelter item or items is more likely than not (or at a higher level of confidence) the proper treatment must comply with each of the following requirements with respect to each such item.

(1) *Factual matters.* (i) The practitioner must make inquiry as to all relevant facts, be satisfied that the opinion takes account of all relevant facts, and be satisfied that the material facts (including factual assumptions and representations) are accurately and completely described in the opinion, and, where appropriate, in any related offering materials or sales promotion materials.

(ii) The opinion must not be based, directly or indirectly, on any unreasonable factual assumptions (including assumptions as to future events). Unreasonable factual assumptions include—

(A) A factual assumption that the practitioner knows or has reason to believe is incorrect, incomplete, inconsistent with an important fact or another factual assumption, or implausible in any material respect; or

(B) A factual assumption regarding a fact or facts that the practitioner could reasonably request to be provided or to be represented.

(C) A factual assumption that the transaction has a business reason, an assumption that the transaction is potentially profitable apart from tax benefits, or an assumption with respect to a material valuation issue.

(iii) A practitioner may, where it would be reasonable based on all the facts and circumstances, rely on factual representations, statements, findings, or agreements of the taxpayer or other persons ((factual representations) (including representa-

tions describing the specific business reasons for the transaction, the potential profitability of the transaction apart from tax benefits, or a valuation prepared by an independent party). Factors relevant to whether such factual representations are reasonable include, but are not limited to, whether the person making the factual representations is knowledgeable as to the facts being represented and is the appropriate person to make such factual representations. A practitioner does not need to conduct an audit or independent verification of a factual representation, but the practitioner may not rely on factual representations if the practitioner knows or has reason to believe, based on his or her background and knowledge, that the relevant information is, or otherwise appears to be, unreasonable, incorrect, incomplete, inconsistent with an important fact or another factual representation, or implausible in any material respect. For example, a representation is incomplete if it states that there are business reasons for the transaction without describing those reasons, or if it states that a transaction is potentially profitable apart from tax benefits without providing adequate factual support. In addition, a valuation is inconsistent with an important fact or factual assumption or is implausible if it appears to be based on facts that are inconsistent with the facts of the transaction.

(iv) If the fair market value of property or the expected financial performance of an investment is relevant to the tax shelter item, a practitioner may not accept an appraisal or financial projection as support for the matters claimed therein unless—

(A) The appraisal or financial projection makes sense on its face;

(B) The practitioner reasonably believes that the person making the appraisal or financial projection is reputable and competent to perform the appraisal or projection; and

(C) The appraisal is based on the definition of fair market value prescribed under the relevant Federal tax provisions.

(v) If the fair market value of purchased property is to be established by reference to its stated purchase price, the practitioner must examine the terms and conditions on which the property was (or is to be) purchased to determine whether the stated

purchase price reasonably may be considered to be its fair market value.

(2) *Relate law to facts.* (i) The opinion must relate the applicable law to the relevant facts.

(ii) The opinion must clearly identify the facts upon which the opinion's conclusions are based.

(iii) The opinion must contain a reasoned analysis of the pertinent facts and legal authorities and must not assume the favorable resolution of any Federal tax issue material to the analysis or otherwise rely on any unreasonable legal assumptions.

(iv) The opinion must not contain legal analyses or conclusions with respect to Federal tax issues that are inconsistent with each other.

(3) *Analysis of material Federal tax issues.* The practitioner must ascertain that all material Federal tax issues have been considered, and that all of those issues which involve the reasonable possibility of a challenge by the Internal Revenue Service have been fully and fairly addressed. The opinion must state that the practitioner has considered the possible application to the facts of all potentially relevant judicial doctrines, including the step transaction, business purpose, economic substance, substance over form, and sham transaction doctrines, as well as potentially relevant statutory and regulatory anti-abuse rules, and the opinion must analyze whether the tax shelter item is vulnerable to challenge under all potentially relevant doctrines and anti-abuse rules. In analyzing such judicial doctrines and statutory and regulatory anti-abuse rules, the opinion must take into account the taxpayer's non-tax and tax purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner.

(4) *Evaluation of material Federal tax issues and overall conclusion.* (i) The practitioner must clearly provide his or her conclusion as to the likelihood that an investor (or, where the practitioner is relying on a representation as to the characteristics of potential investors, a typical investor of the type to whom the tax shelter is or will be marketed) will prevail on the merits with respect to each material Federal tax issue that involves the reasonable possibility of a challenge by the

Internal Revenue Service. This requirement is not satisfied by including a statement in the opinion that the practitioner was unable to opine with respect to certain material Federal tax issues, including but not limited to whether the transaction has a business purpose or economic substance.

(ii) The opinion must unambiguously conclude that the Federal tax treatment of the tax shelter item or items is more likely than not (or at a higher level of confidence) the proper tax treatment. A favorable overall conclusion may not be based solely on the conclusion that the taxpayer more likely than not will prevail on the merits of each material Federal tax issue.

(iii) In ascertaining that all material Federal tax issues have been considered, evaluating the merits of those issues and evaluating whether the Federal tax treatment of the tax shelter item or items is the proper tax treatment, the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.

(5) *Description of opinion.* The practitioner must take reasonable steps to assure that any written materials or promotional efforts that distribute, reflect or refer to the tax shelter opinion, correctly and fairly represent the nature and extent of the opinion.

(b) *Competence to provide opinion; reliance on opinions of others.* (1) The practitioner must be knowledgeable in all of the aspects of Federal tax law relevant to the opinion being rendered. If the practitioner is not sufficiently knowledgeable to render an informed opinion with respect to particular material Federal tax issues, then the practitioner may rely on the opinion of another practitioner with respect to such issues, provided the practitioner is satisfied that the other practitioner is sufficiently knowledgeable regarding such issues and the practitioner does not know and has no reason to believe that such opinion should not be relied on.

(2) To the extent the practitioner relies on an opinion of another practitioner, the opinion rendered by the practitioner must identify the other practitioner, state the date on which the opinion was rendered, and set forth the conclusions reached in such opinion.

(3) The practitioner also must be satisfied that the combined analysis, taken as a whole, satisfies the requirements of this §10.35.

(4) *Financial forecasts and projections.* A practitioner who makes financial forecasts or projections relating to or based on the tax consequences of the tax shelter item that are included in written materials disseminated to any or all of the same persons as the opinion may rely on the opinion of another practitioner as to any or all material Federal tax issues, provided that the practitioner who desires to rely on the other opinion has no reason to believe the practitioner rendering such other opinion has not complied with the standards of paragraph (a) of this §10.35, is satisfied that the other practitioner is sufficiently knowledgeable and does not know and has no reason to believe that the opinion of the other practitioner should not be relied on. The practitioner's report must disclose any material Federal tax issue not covered by, or incorrectly opined on, by the other opinion, and shall set forth his or her opinion with respect to each such issue in a manner that satisfies the requirements of paragraph (a) of this section.

(c) *Definitions.* For purposes of this section—

(1) *Practitioner* includes any individual described in paragraph (f) of §10.2.

(2) The definition of *tax shelter* is set forth in section 6662(d)(2)(C)(iii) of the Internal Revenue Code. Excluded from the term are municipal bonds and qualified retirement plans.

(3) A *tax shelter item* is an item of income, gain, loss, deduction or credit if the item is directly or indirectly attributable to a tax shelter as defined in section 6662(d)(2)(C)(iii) of the Internal Revenue Code.

(4) A *tax shelter opinion*, as the term is used in this section, is written advice by a practitioner concerning the Federal tax aspects of a tax shelter item or items. The term tax shelter opinion includes the Federal tax aspects or tax risks portion of offering materials prepared by or at the direction of a practitioner, whether or not a separate opinion letter is issued and whether or not the practitioner's name is referred to in offering materials or in connection with sales promotion efforts. Similarly, a financial forecast or projec-

tion prepared by a practitioner is a tax shelter opinion if it is predicated on assumptions regarding Federal tax aspects of the investment and that meets the other requirements of the first sentence of this paragraph. The term tax shelter opinion does not include advice provided in connection with the review of portions of offering materials or sales promotion materials, provided neither the name of the practitioner or the practitioner's firm nor the fact that a practitioner has rendered advice concerning the Federal tax aspects, is referred to in the offering materials or related sales promotion materials.

(5) A *material Federal tax issue*, as the term is used in this section, is any Federal tax issue the resolution of which could have a significant impact (whether beneficial or adverse) on a taxpayer under any reasonably foreseeable circumstance.

(d) *Effect of opinion that meets these standards.* An opinion of a practitioner that meets these requirements will satisfy the practitioner's responsibilities under this section, but the persuasiveness of the opinion with regard to the tax issues in question and the taxpayer's good faith reliance on the opinion will be separately determined under applicable provisions of the law and regulations.

(e) For purposes of advising the Director of Practice whether an individual may have violated §10.33 or 10.35, the Director is authorized to establish an Advisory Committee composed of at least five individuals authorized to practice before the Internal Revenue Service. Under procedures established by the Director, such Advisory Committee will, at the request of the Director, review and make recommendations with regard to the alleged violations of §10.33 or 10.35.

§10.36 Procedures to ensure compliance.

A practitioner who is a member of, associated with, or employed by a firm must take reasonable steps, consistent with his or her authority and responsibility for the firm's practice advising clients regarding matters arising under the Federal tax laws, to make certain that the firm has adequate procedures in effect for purposes of ensuring compliance with §10.33, 10.34, and 10.35. The Director of Practice may take disciplinary action against any practitioner for failing to comply with

the requirements of the preceding sentence if, and only if—

(a) The practitioner through willfulness, recklessness, or gross incompetence does not take such reasonable steps and the practitioner and one or more persons who are members of, associated with, or employed by the firm have, in connection with their practice with the firm, engaged in a pattern or practice of failing to comply with §10.33, 10.34 or 10.35; or

(b) The practitioner takes such reasonable steps but has actual knowledge that one or more persons who are members of, associated with, or employed by the firm have, in connection with their practice with the firm, engaged in a pattern or practice of failing to comply with §10.33, 10.34 or 10.35 and the practitioner, through willfulness, recklessness, or gross incompetence, fails to take prompt action, consistent with his or her authority and responsibility for the firm's practice advising clients regarding matters under the Federal tax laws, to correct such pattern or practice.

Subpart C — Sanctions for Violation of the Regulations

§10.50 Sanctions.

(a) *Authority to censure, suspend, or disbar.* The Secretary of the Treasury, or his or her designate, after notice and an opportunity for a proceeding, may censure, suspend or disbar any practitioner from practice before the Internal Revenue Service if the practitioner is shown to be incompetent or disreputable, fails to comply with any regulation in this part, or with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client. Censure is a public reprimand.

(b) *Authority to disqualify.* The Secretary of the Treasury, or his or her designate, after due notice and opportunity for hearing, may disqualify any appraiser with respect to whom a penalty has been assessed under section 6701(a) of the Internal Revenue Code.

(1) If any appraiser is disqualified pursuant to this subpart C, such appraiser is barred from presenting evidence or testimony in any administrative proceeding before the Department of Treasury or the Internal Revenue Service, regardless of whether such evidence or testimony

would pertain to an appraisal made prior to or after such date.

(2) Any appraisal made by a disqualified appraiser after the effective date of disqualification will not have any probative effect in any administrative proceeding before the Department of the Treasury or the Internal Revenue Service. However, an appraisal otherwise barred from admission into evidence pursuant to this section may be admitted into evidence solely for the purpose of determining the taxpayer's reliance in good faith on such appraisal.

§10.51 Incompetence and disreputable conduct.

Incompetence and disreputable conduct for which a practitioner may be censured, suspended or disbarred from practice before the Internal Revenue Service includes, but is not limited to—

(a) Conviction of any criminal offense under the revenue laws of the United States;

(b) Conviction of any criminal offense involving dishonesty, or breach of trust;

(c) Conviction of any felony under Federal or State law for which the conduct involved renders the practitioner unfit to practice before the Internal Revenue Service;

(d) Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof, or to any tribunal authorized to pass upon Federal tax matters, in connection with any matter pending or likely to be pending before them, knowing such information to be false or misleading. Facts or other matters contained in testimony, Federal tax returns, financial statements, applications for enrollment, affidavits, declarations, or any other document or statement, written or oral, are included in the term *information*.

(e) Solicitation of employment as prohibited under §10.30, the use of false or misleading representations with intent to deceive a client or prospective client in order to procure employment, or intimating that the practitioner is able improperly to obtain special consideration or action from the Internal Revenue Service or officer or employee thereof.

(f) Willfully failing to make a Federal tax return in violation of the revenue laws of the United States, willfully evading, at-

tempting to evade, or participating in any way in evading or attempting to evade any assessment or payment of any Federal tax, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof.

(g) Misappropriation of, or failure properly and promptly to remit funds received from a client for the purpose of payment of taxes or other obligations due the United States.

(h) Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the official action of any officer or employee of the Internal Revenue Service by the use of threats, false accusations, duress or coercion, by the offer of any special inducement or promise of advantage or by the bestowing of any gift, favor or thing of value.

(i) Disbarment or suspension from practice as an attorney, certified public accountant, public accountant, or actuary by any duly constituted authority of any State, possession, territory, Commonwealth, the District of Columbia, any Federal court of record or any Federal agency, body or board.

(j) Knowingly aiding and abetting another person to practice before the Internal Revenue Service during a period of suspension, disbarment, or ineligibility of such other person.

(k) Contemptuous conduct in connection with practice before the Internal Revenue Service, including the use of abusive language, making false accusations and statements, knowing them to be false, or circulating or publishing malicious or libelous matter.

(l) Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or engaging in a pattern of providing incompetent opinions on questions arising under the Federal tax laws. False opinions described in this paragraph (l) include those which reflect or result from a knowing misstatement of fact or law, from an assertion of a position known to be unwarranted under existing law, from counseling or assisting in conduct known to be illegal or fraudulent, from concealing matters required by law to be revealed, or from consciously disregarding information indicating that material facts ex-

pressed in the tax opinion or offering material are false or misleading. For purposes of this paragraph, reckless conduct is a highly unreasonable omission or misrepresentation involving an extreme departure from the standards of ordinary care that a practitioner should observe under the circumstances. A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted knowingly, recklessly, or through gross incompetence. Gross incompetence includes conduct that reflects gross indifference, preparation which is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client.

§10.52 Violation of regulations.

A practitioner may be censured, suspended or disbarred from practice before the Internal Revenue Service for any of the following—

(a) Willfully violating any of the regulations contained in this part.

(b) Recklessly or through gross incompetence (within the meaning of §10.51(l)) violating §10.33, 10.34, or 10.35.

§10.53 Receipt of information concerning practitioner.

(a) *Officer or employee of the Internal Revenue Service.* If an officer or employee of the Internal Revenue Service has reason to believe that a practitioner has violated any provision of this part, the officer or employee will promptly make a written report to the Director of Practice of the alleged violation.

(b) *Other persons.* Any person other than an officer or employee of the Internal Revenue Service having information of a violation of any provision of this part may make an oral or written report of the alleged violation to the Director of Practice or any officer or employee of the Service. If the report is made to an officer or employee of the Service, the officer or employee will make a written report of the alleged violation to the Director.

Subpart D — Rules Applicable to Disciplinary Proceedings

§10.60 Institution of proceeding.

(a) Whenever the Director of Practice determines that a practitioner violated any

provision of the laws or regulations governing practice before the Internal Revenue Service, the Director may reprimand the practitioner or, in accordance with §10.62, institute a proceeding for censure, suspension, or disbarment of the practitioner.

(b) Whenever the Director of Practice is advised or becomes aware that a penalty has been assessed against an appraiser under section 6701(a) of the Internal Revenue Code, the Director may reprimand the appraiser or, in accordance with §10.62, institute a proceeding for disqualification of the appraiser.

(c) A proceeding for censure, suspension, or disbarment of a practitioner or disqualification of an appraiser is instituted by the filing of a complaint, the contents of which are more fully described in §10.62. Except as provided in §10.82, a proceeding will not be instituted under this section unless the proposed respondent previously has been advised in writing of the facts or conduct warranting such action and has been accorded an opportunity to provide an explanation or description of mitigating circumstances.

§10.61 Conferences.

(a) *In general.* The Director of Practice may confer with a practitioner or an appraiser concerning allegations of misconduct irrespective of whether a proceeding for censure, suspension, disbarment, or disqualification has been instituted against the practitioner or appraiser. If the conference results in a stipulation in connection with a proceeding in which the practitioner or appraiser is the respondent, the stipulation may be entered in the record by either party to the proceeding.

(b) *Resignation or voluntary suspension or censure.* To avoid the institution or conclusion of a proceeding under paragraph (a) of §10.60, a practitioner may offer his or her consent to the issuance of a censure, suspension or disbarment, or may resign, as the case may be, from practice before the Internal Revenue Service. It is within the discretion of the Director of Practice to accept the offered censure, suspension, disbarment, or resignation, in accordance with the consent offered.

(c) *Voluntary disqualification.* To avoid the institution or conclusion of a

proceeding under paragraph (b) of §10.60, an appraiser may offer his or her consent to disqualification. It is within the discretion of the Director of Practice to accept the offered disqualification in accordance with the consent offered.

§10.62 Contents of complaint.

(a) *Charges.* A complaint must name the respondent, give a plain and concise description of the allegations that constitute the basis for the proceeding, and be signed by the Director of Practice. A complaint is sufficient if it fairly informs the respondent of the charges brought so that he or she is able to prepare a defense. In the case of a complaint filed against an appraiser, the complaint is sufficient if it refers to a penalty imposed previously on the respondent under section 6701(a) of the Internal Revenue Code.

(b) *Demand for answer.* The Director of Practice must notify the respondent of the place and time for answering the complaint, the time for which may not be less than 15 days from the date of service of the complaint, and notice must be given that a decision by default may be rendered against the respondent in the event an answer is not filed as required.

§10.63 Service of complaint and other papers.

(a) *Complaint.* The complaint or a copy of the complaint must be served on the respondent by certified mail or first class mail, as provided below; by delivering it to the respondent or the respondent's authorized representative in person; by leaving it at the office or place of business of the respondent or the respondent's authorized representative; or in any other manner that has been agreed to by the respondent. Where service is by certified mail, the returned post office receipt duly signed by or on behalf of the respondent will be proof of service. If the certified mail is not claimed or accepted by the respondent and is returned undelivered, complete service may be made on the respondent by mailing the complaint to the respondent by first class mail, provided the complaint is addressed to the respondent at the respondent's last known address as determined under section 6212 of the Internal Revenue Code and the regulations thereunder. If service is made on the respondent or the respondent's autho-

rized representative in person, by leaving the complaint at the office or place of business of the respondent or the respondent's authorized representative, or by other means agreed to by the respondent, the sworn or affirmed written statement of service by the person making service, setting forth the manner of service, including the place, recipient, date and time of service, will be proof of service.

(b) *Service of papers other than complaint.* Any paper other than the complaint may be served on the respondent as provided in paragraph (a) of this section or by mailing the paper by first class mail to the respondent at his or her last known address as determined under section 6212 of the Internal Revenue Code and the regulations thereunder, or by mailing the paper by first class mail to the respondent's authorized representative. This mailing constitutes complete service.

(c) *Filing of papers.* Whenever the filing of a paper is required or permitted in connection with a proceeding under this part, and the place of filing is not specified by these regulations, rule, or order of the Administrative Law Judge, the paper must be filed with the Director of Practice, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224. All papers must be filed in duplicate.

§10.64 Answer.

(a) *Filing.* The respondent's answer must be filed in writing within the time specified in the complaint unless, on application of the respondent, the time is extended by the Director of Practice or the Administrative Law Judge. The answer is to be filed in duplicate with the Director.

(b) *Contents.* The answer must contain a statement of facts that constitute the respondent's grounds of defense. The respondent must specifically admit or deny each allegation set forth in the complaint, except that the respondent may state that the respondent is without sufficient information to admit or deny a specific allegation. The respondent, nevertheless, may not deny a material allegation in the complaint which the respondent knows to be true, or state that the respondent is without sufficient information to form a belief, when the respondent possesses the required information.

The respondent also must state affirmatively any special matters of defense on which he or she relies.

(c) *Failure to deny or answer allegations in the complaint.* Every allegation in the complaint that is not denied in the answer is deemed admitted and may be considered proved; no further evidence in respect of such allegation need be adduced at a hearing. Failure to file an answer within the time prescribed (or within the time for answer as extended by the Director of Practice or the Administrative Law Judge), constitutes an admission of the allegations of the complaint and a waiver of hearing, and the Administrative Law Judge may make the decision by default without a hearing or further procedure.

(d) *Signature.* The answer must be signed by the respondent or the respondent's authorized representative and must include a statement directly above the signature acknowledging that the statements made in the answer are true and correct and that knowing and willful false statements may be punishable under 18 U.S.C. 1001.

§10.65 Supplemental charges.

If it appears that the respondent, in his or her answer, falsely and in bad faith, denies a material allegation of fact in the complaint or states that the respondent has insufficient knowledge to form a belief, when the respondent in fact possesses such information, or if it appears that the respondent has knowingly introduced false testimony during proceedings for his or her censure, suspension, disbarment, or disqualification, the Director of Practice may file supplemental charges against the respondent. The supplemental charges may be tried with other charges in the case, provided the respondent is given due notice of the charges and is afforded an opportunity to prepare a defense to such charges.

§10.66 Reply to answer.

The Director of Practice may file a reply to the respondent's answer, but unless otherwise ordered by the Administrative Law Judge, no reply to the respondent's answer is required. If a reply is not filed, new matter in the answer is deemed denied.

§10.67 Proof; variance; amendment of pleadings.

In the case of a variance between the allegations in pleadings and the evidence adduced in support of the pleadings, the Administrative Law Judge may order or authorize amendment of the pleadings to conform to the evidence. The party who would otherwise be prejudiced by the amendment must be given a reasonable opportunity to address the allegations of the pleadings as amended and the Administrative Law Judge must make findings on any issue presented by the pleadings as amended.

§10.68 Motions and requests.

Unless the Administrative Law Judge directs otherwise, motions and requests may be filed with the Director of Practice or with the Administrative Law Judge.

§10.69 Representation.

A respondent or proposed respondent may appear in person or he or she may be represented by a practitioner. The Director of Practice may be represented by an attorney or other employee of the Internal Revenue Service.

§10.70 Administrative Law Judge.

(a) *Appointment.* Proceedings on complaints for the censure, suspension or disbarment of a practitioner or the disqualification of an appraiser will be conducted by an Administrative Law Judge appointed as provided by 5 U.S.C. 3105.

(b) *Powers of the Administrative Law Judge.* The Administrative Law Judge, among other powers, has the authority, in connection with any proceeding under §10.60 assigned or referred to him or her, to do the following—

(1) Administer oaths and affirmations;

(2) Make rulings on motions and requests, which rulings may not be appealed prior to the close of a hearing except in extraordinary circumstances and at the discretion of the Administrative Law Judge;

(3) Determine the time and place of hearing and regulate its course and conduct;

(4) Adopt rules of procedure and modify the same from time to time as needed for the orderly disposition of proceedings;

(5) Rule on offers of proof, receive relevant evidence, and examine witnesses;

(6) Take or authorize the taking of depositions;

(7) Receive and consider oral or written argument on facts or law;

(8) Hold or provide for the holding of conferences for the settlement or simplification of the issues with the consent of the parties;

(9) Perform such acts and take such measures as are necessary or appropriate to the efficient conduct of any proceeding; and

(10) Make decisions.

§10.71 Hearings.

(a) *In general.* An Administrative Law Judge will preside at the hearing on a complaint filed under paragraph (c) of §10.60 for the censure, suspension, or disbarment of a practitioner or disqualification of an appraiser. Hearings will be stenographically recorded and transcribed and the testimony of witnesses will be taken under oath or affirmation. Hearings will be conducted pursuant to 5 U.S.C. 556. A hearing in a proceeding requested under paragraph (g) of §10.82 will be conducted *de novo*.

(b) *Failure to appear.* If either party to the proceeding fails to appear at the hearing, after notice of the proceeding has been sent to him or her, the party will be deemed to have waived the right to a hearing and the Administrative Law Judge may make his or her decision against the absent party by default.

§10.72 Evidence.

(a) *In general.* The rules of evidence prevailing in courts of law and equity are not controlling in hearings on complaints filed under paragraph (c) of §10.60. However, the Administrative Law Judge may exclude evidence that is irrelevant, immaterial, or unduly repetitious.

(b) *Depositions.* The deposition of any witness taken pursuant to §10.73 may be admitted into evidence in any proceeding instituted under §10.60.

(c) *Proof of documents.* Official documents, records, and papers of the Internal Revenue Service and the Office of Director of Practice are admissible in evidence without the production of an officer or employee to authenticate them. Any such

documents, records, and papers may be evidenced by a copy attested or identified by an officer or employee of the Service or the Treasury Department, as the case may be.

(d) *Exhibits.* If any document, record, or other paper is introduced in evidence as an exhibit, the Administrative Law Judge may authorize the withdrawal of the exhibit subject to any conditions that he or she deems proper.

(e) *Objections.* Objections to evidence are to be made in short form, stating the grounds for the objection. Except as ordered by the Administrative Law Judge, argument on objections will not be recorded or transcribed. Rulings on objections are to be a part of the record, but no exception to a ruling is necessary to preserve the rights of the parties.

§10.73 Depositions.

(a) Depositions for use at a hearing may be taken, with the written approval of the Administrative Law Judge, by either the Director of Practice or the respondent or their duly authorized representatives. Depositions may be taken before any officer duly authorized to administer an oath for general purposes or before an officer or employee of the Internal Revenue Service who is authorized to administer an oath in internal revenue matters.

(b) The party taking the deposition must provide the deponent and the other party with 10 days written notice of the deposition, unless the deponent and the parties agree otherwise. The notice must specify the name of the deponent, the time and place where the deposition is to be taken, and whether the deposition will be taken by oral or written interrogatories. When a deposition is taken by written interrogatories, any cross-examination also will be by written interrogatories. Copies of the written interrogatories must be served on the other party with the notice of deposition, and copies of any written cross-interrogation must be mailed or delivered to the opposing party at least 5 days before the date that the deposition will be taken, unless the parties mutually agree otherwise. A party on whose behalf a deposition is taken must file the responses to the written interrogatories or a transcript of the oral deposition with the Administrative Law Judge and serve copies on the opposing party and the de-

ponent. Expenses in the reporting of depositions will be borne by the party that requested the deposition.

§10.74 Transcript.

In cases where the hearing is stenographically reported by a Government contract reporter, copies of the transcript may be obtained from the reporter at rates not to exceed the maximum rates fixed by contract between the Government and the reporter. Where the hearing is stenographically reported by a regular employee of the Internal Revenue Service, a copy will be supplied to the respondent either without charge or upon the payment of a reasonable fee. Copies of exhibits introduced at the hearing or at the taking or depositions will be supplied to the parties upon the payment of a reasonable fee (Sec. 501, Public Law 82-137)(65 Stat. 290)(31 U.S.C. 483a).

§10.75 Proposed findings and conclusions.

Except in cases where the respondent has failed to answer the complaint or where a party has failed to appear at the hearing, the parties must be afforded a reasonable opportunity to submit proposed findings and conclusions and their supporting reasons to the Administrative Law Judge.

§10.76 Decision of the Administrative Law Judge.

As soon as practicable after the conclusion of a hearing and the receipt of any proposed findings and conclusions timely submitted by the parties, the Administrative Law Judge will make the decision in the case. The decision must include a statement of findings and conclusions, as well as the reasons or basis for making such findings and conclusions, and an order of censure, suspension, disbarment, disqualification, or dismissal of the complaint. The Administrative Law Judge will file the decision with the Director of Practice, who will transmit a copy of the decision to the respondent or the respondent's authorized representative. In the absence of an appeal to the Secretary of the Treasury, or review of the decision on motion of the Secretary, the decision of the Administrative Law Judge will without fur-

ther proceedings become the decision of the Secretary of the Treasury 30 days after the date of the Administrative Law Judge's decision.

§10.77 Appeal to the Secretary.

Within 30 days from the date of the Administrative Law Judge's decision, either party may appeal to the Secretary of the Treasury, or his or her designate. The respondent must file his or her appeal with the Director of Practice in duplicate and notice of appeal must include exceptions to the decision of the Administrative Law Judge and supporting reasons for such exceptions. If the Director files an appeal, he or she must transmit a copy to the respondent. Within 30 days after receipt of an appeal or copy thereof, the other party may file a reply brief in duplicate with the Director. If the reply brief is filed by the Director, he or she must transmit a copy of it to the respondent. The Director must transmit the entire record to the Secretary of the Treasury, or his or her designate, after the appeal and any reply brief has been filed.

§10.78 Decision of the Secretary.

On appeal from or review of the decision of the Administrative Law Judge, the Secretary of the Treasury, or his or her designate, will make the agency decision. A copy of the agency's decision will be transmitted to the respondent by the Director of Practice.

§10.79 Effect of disbarment, suspension, or censure.

(a) *Disbarment.* Where the final order in a case is against the respondent and is for disbarment, the respondent will not be permitted to practice before the Internal Revenue Service unless and until authorized to do so by the Director of Practice pursuant to §10.81.

(b) *Suspension.* Where the final order in a case is against the respondent and is for suspension, the respondent will not be permitted to practice before the Internal Revenue Service during the period of suspension.

(c) *Censure.* Where the final order in the case is against the respondent and is for censure, the respondent may be permitted to practice before the Internal Revenue Service, but the respondent's future

representations may be subject to conditions prescribed by the Director of Practice designed to promote high standards of conduct. For example, where a practitioner is censured because he or she failed to advise his or her clients about a potential conflict of interest and obtain the clients' written consents, the Director of Practice may require the practitioner to provide the Director or another Internal Revenue Service official with a copy of all future consents obtained by the practitioner, whether or not such consents are specifically requested.

§10.80 Notice of disbarment, suspension, censure, or disqualification.

On the issuance of a final order censuring, suspending, or disbarring a practitioner or a final order disqualifying an appraiser, the Director of Practice may give notice of the censure, suspension, disbarment, or disqualification to appropriate officers and employees of the Internal Revenue Service and to interested departments and agencies of the Federal government. The Director may determine the manner of giving notice to the proper authorities of the State by which the censured, suspended, or disbarred person was licensed to practice.

§10.81 Petition for reinstatement.

The Director of Practice may entertain a petition for reinstatement from any person disbarred from practice before the Internal Revenue Service or any disqualified appraiser after the expiration of 5 years following such disbarment or disqualification. Reinstatement may not be granted unless the Director is satisfied that the petitioner, thereafter, is not likely to conduct himself contrary to the regulations in this part, and that granting such reinstatement would not be contrary to the public interest.

§10.82 Expedited suspension upon criminal conviction or loss of license for cause.

(a) *When applicable.* Whenever the Director of Practice determines that a practitioner is described in paragraph (b) of this section, the Director may institute a proceeding under this section to suspend the practitioner from practice before the Internal Revenue Service.

(b) *To whom applicable.* This section applies to any practitioner who, within 5 years of the date a complaint instituting a proceeding under this section is served—

(1) Has had his or her license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause (not including a failure to pay a professional licensing fee) by any authority or court, agency, body, or board described in §10.51(i); or

(2) Has been convicted of any crime under title 26 of the United States Code, any crime involving dishonesty or breach of trust, or any felony for which the conduct involved renders the practitioner unfit to practice before the Internal Revenue Service.

(c) *Instituting a proceeding.* A proceeding under this section will be instituted by a complaint that names the respondent, is signed by the Director of Practice, is filed in the Director's office, and is served according to the rules set forth in paragraph (a) of §10.63. The complaint must give a plain and concise description of the allegations that constitute the basis for the proceeding. The complaint must notify the respondent—

(1) Of the place and due date for filing an answer;

(2) That a decision by default may be rendered if the respondent fails to file an answer as required;

(3) That the respondent may request a conference with the Director of Practice to address the merits of the complaint and that any such request must be made in the answer; and

(4) That the respondent may be suspended either immediately following the expiration of the period by which an answer must be filed or, if a conference is requested, immediately following the conference.

(d) *Answer.* The answer to a complaint described in this section must be filed no later than 30 calendar days following the date the complaint is served, unless the Director of Practice extends the time for filing. The answer must be filed in accordance with the rules set forth in §10.64, except as otherwise provided in this section. A respondent is entitled to a conference with the Director only if the conference is requested in a timely filed answer. If a request for a conference is not made

in the answer or the answer is not timely filed, the respondent will be deemed to have waived his or her right to a conference and the Director may suspend such respondent at any time following the date on which the answer was due.

(e) *Conference.* The Director of Practice or his or her designee will preside at a conference described in this section. The conference will be held at a place and time selected by the Director, but no sooner than 14 calendar days after the date by which the answer must be filed with the Director, unless the respondent agrees to an earlier date. An authorized representative may represent the respondent at the conference. Following the conference, upon a finding that the respondent is described in paragraph (b) of this section, or upon the respondent's failure to appear at the conference either personally or through an authorized representative, the Director may immediately suspend the respondent from practice before the Internal Revenue Service.

(f) *Duration of suspension.* A suspension under this section will commence on the date that written notice of the suspension is issued. A practitioner's suspension will remain effective until the earlier of the following—

(1) The Director of Practice lifts the suspension after determining that the practitioner is no longer described in paragraph (b) of this section or for any other reason; or

(2) The suspension is lifted by an Administrative Law Judge or the Secretary of the Treasury in a proceeding referred to in paragraph (g) of this section and instituted under §10.60.

(g) *Proceeding instituted under §10.60.* If the Director of Practice suspends a practitioner under this section, the practitioner may ask the Director to issue a complaint under §10.60. The request must be made in writing within 2 years from the date on which the practitioner's suspension commences. The Director must issue a complaint requested under this paragraph within 30 calendar days of receiving the request.

Subpart E — General Provisions

§10.90 Records.

(a) *Availability.* The Director of Practice will make available for public inspection

tion at the Office of Director of Practice the roster of all persons enrolled to practice, the roster of all persons censured, suspended, or disbarred from practice before the Internal Revenue Service, and the roster of all disqualified appraisers. Other records of the Director may be disclosed upon specific request, in accordance with the applicable disclosure rules of the Internal Revenue Service and the Treasury Department.

(b) *Disciplinary procedures.* A request by a practitioner or appraiser that a hearing in a disciplinary proceeding concerning him or her be public, and that the record of such disciplinary proceeding be made available for inspection by interested persons may be granted by the Director of Practice where the parties stipulate in advance to protect from disclosure confidential tax information in accordance with all applicable statutes and regulations.

§10.91 Saving clause.

Any proceeding instituted under this part, but not closed prior to the effective date of these revised regulations, will not be affected by the revisions. Any proceeding under this part based on conduct engaged in prior to the effective date of these regulations may be instituted subsequent to the effective date of these revisions. Conduct engaged in prior to the effective date of these regulations is subject to the regulations in effect at the time the conduct occurred.

§10.92 Special orders.

The Secretary of the Treasury reserves the power to issue such special orders as he or she deems proper in any cases within the purview of this part.

§10.93 Effective date.

Subject to §10.91, Part 10 is applicable on the date final regulations are published in the **Federal Register**.

Robert E. Wenzel,
*Deputy Commissioner
of Internal Revenue.*

Approved January 3, 2001.

Jonathan Talisman,
Assistant Secretary (Tax Policy).

(Filed by the Office of the Federal Register on January 11, 2001, 8:45 a.m., and published in the issue of

the Federal Register for January 12, 2001, 66 F.R. 3276)

Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance on Reporting of Deposit Interest Paid to Nonresident Aliens

REG-126100-00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance on the reporting requirements for interest on deposits maintained at the U.S. office of certain financial institutions and paid to nonresident alien individuals. These proposed regulations affect persons making payments of interest with respect to such a deposit. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by February 27, 2001. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for 10 a.m. on March 21, 2001, must be received by February 27, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG-126100-00), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions also may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG-126100-00), Courier's Desk, Internal Revenue Service 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax_regs/regslst.html. The public hearing will be held in Room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regula-

tions, Kate Y. Hwa (202), 622-3840 (not a toll free number); concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Lanita Vandyke, (202) 622-7180 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S:O, Washington, DC 20224. Comments on the collections of information should be received by April 16, 2001. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper operation of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collection of information in these proposed regulations is in §§1.6049-4(b)(5)(i), 1.6049-6(e)(4)(i), and (ii). This information is required to determine if taxpayers have properly reported amounts received as income. The collection of information is mandatory. The likely respondents are businesses and other for-profit institutions.

The estimated average annual burden per respondent and/or recordkeeper required by §§1.6049-4(b)(5)(i), 1.6049-6(e)(4)(i), and (ii) will be reflected in the burdens of Forms W-8, 1042, 1042-S, and the income tax return of a foreign person.

Further, the estimated average annual burden per respondent and/or recordkeeper for the statement required by §1.6049-6(e)(4)(i) is as follows:

Estimated total annual reporting burden: 500 hours.

Estimated average annual burden per respondent: 15 minutes.

Estimated number of respondents: 2,000.

Estimated annual frequency of responses: annually.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background and Explanation of Provisions

The IRS previously determined that information concerning interest paid on deposits from U.S. bank accounts to nonresident alien individuals who are residents of Canada would be significant in furthering its compliance efforts. Consequently, §1.6049-8(a) requires the reporting of such interest on a Form 1042-S.

The proposed regulations extend the information reporting requirement for bank deposit interest paid to nonresident alien individuals who are residents of other foreign countries. This extension is appropriate for two reasons. First, requiring routine reporting to the IRS of all bank deposit interest paid within the United States will help to ensure voluntary compliance by U.S. taxpayers by minimizing the possibility of avoidance of the U.S. information reporting system (such as through false claims of foreign status). Second, several countries that have tax treaties or

other agreements that provide for the exchange of tax information with the United States have requested information concerning bank deposits of individual residents of their countries. Because of the importance that the United States attaches to exchanging tax information as a way of encouraging voluntary compliance and furthering transparency, see e.g. S. Exec. Rep. No. 106-8, at 15 (1st Sess. 1999), Treasury and the IRS believe it is important for the United States to facilitate, wherever possible, the effective exchange of all relevant tax information with our treaty partners.

In addition to extending the information reporting requirement for interest paid on deposits maintained at a bank's office within the United States to all nonresident alien individuals, the proposed regulations also make the following minor changes and clarifications.

Section 1.6049-6 provides that a copy of Form 1042-S must be furnished to the recipient for interest paid on deposits maintained at a bank's office within the United States. Paragraph (e)(4)(i) of that section has been revised to clarify that the payor or middleman can satisfy this requirement by furnishing a copy of Form 1042-S either in person or to the last known address of the recipient.

A new paragraph (e)(4)(ii) has been added to §1.6049-6 to provide guidance on the manner in which a Form 1042-S is furnished when there are joint account holders. Specifically, if any joint account holder is a U.S. non-exempt recipient, the payor or middleman must report the entire payment to that person. If all joint account holders are foreign persons, the payor or middleman must report the payment to the nonresident alien individual that is a resident of a country with which the United States has an income tax treaty or a tax information exchange agreement (TIEA). If more than one of the joint account holders is a foreign person and is a resident of a country with which the United States has an income tax treaty or a TIEA, the payor or middleman must report the payment to the person that is the primary account holder. The payor or middleman must, however, furnish a Form 1042-S to any account holder who requests it.

Section 1.6049-8(a) provides that interest paid with respect to a deposit maintained at an office within the United States to individuals who are Canadian residents must be reported. The payor or middleman may rely on the permanent address found on Form W-8 to make the determination of whether the nonresident alien individual resides in Canada. However, the regulation also provides that a payor or middleman may rely on its actual knowledge of the individual's residence address in Canada, even if a valid Form W-8 has not been provided, to make such a determination. This "actual knowledge of the individual's residence address" rule has been eliminated because it creates a result that is contrary to the presumption rules contained in §1.1441-1(b)(3)(iii) (and made applicable to reportable payments by §1.6049-5(d)(2)). Accordingly, §1.6049-8(a) has been clarified to provide that, while amounts described in §1.6049-8(a) generally are not subject to backup withholding under section 3406, the payor must report the payment on a Form 1099 as made to a U.S. non-exempt recipient in accordance with the presumption rules of §§1.6049-5(d)(2) and 1.1441-1(b)(3)(iii) if the payor or middleman does not have either a valid Form W-8 or valid Form W-9. Further, such payment is subject to backup withholding under section 3406.

Proposed Effective Date

These regulations are proposed to apply to payments made after December 31 of the year in which they are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief

Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely (in the manner described in the "ADDRESSES" portion of this preamble) to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for March 31, 2001, beginning at 10 a.m. in Room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by February 27, 2001. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for reviewing outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of the regulations is Kate Y. Hwa, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury

Department participated in their development.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 31 are proposed to be amended as follows:

PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In section 1.6049-4, paragraph (b)(5) is revised to read as follows:

§1.6049-4 Return of information as to interest paid and original issue discount includible in gross income after December 31, 1982.

* * * * *

(b) * * *

(5) *Interest payments to nonresident alien individuals*—(i) *General rule.* In the case of interest aggregating \$10 or more paid to a nonresident alien individual (as defined in section 7701(b)(1)(B)) that is reportable under §1.6049-8(a), the payor shall make an information return on Form 1042-S for the calendar year in which the interest is paid. The payor or middleman shall prepare and file Form 1042-S at the time and in the manner prescribed by section 1461 and the regulations under that section and by the form and its accompanying instructions. See §§1.1461-1(b) (rules regarding the preparation of a Form 1042) and 1.6049-6(e)(4) (rules for furnishing a copy of the Form 1042-S to the payee). To determine whether an information return is required for original issue discount, see §§1.6049-5(f) and 1.6049-8(a).

(ii) *Effective date.* Paragraph (b)(5)(i) of this section shall be effective for payments made after December 31 of the year in which the final regulations are published in the **Federal Register** with respect to a Form W-8 (Certificate of Foreign Status) furnished to the payor or middleman after that date. (For interest paid to a Canadian nonresident alien individual on or before December 31 of the year in which final regulations are published in the **Federal Register**, see §1.6049-4(b)(5) as in effect and contained in 26 CFR part 1 revised April 1, 2000.)

* * * * *

Par. 3. Section 1.6049-6 is amended as follows:

1. Paragraph (e)(4) is revised.

2. In paragraph (e)(5), the first sentence is revised and a new sentence is added at the end of the paragraph.

The addition and revisions read as follows:

§1.6049-6 Statements to recipients of interest payments and holders of obligations for attributed original issue discount.

* * * * *

(e) * * *

(4) *Special rule for amounts described in §1.6049-8(a)*—(i) *In general.* In the case of amounts described in §1.6049-8(a) (relating to payments of deposit interest to nonresident alien individuals) paid after December 31 of the year in which the final regulations are published in the **Federal Register**, any person who makes a Form 1042-S under section 6049(a) and §1.6049-4(b)(5) shall furnish a statement to the recipient either in person or by first-class mail to the recipient's last known address. The statement shall include a copy of the Form 1042-S required to be prepared pursuant to §1.6049-4(b)(5) and a statement to the effect that the information on the form is being furnished to the United States Internal Revenue Service and may be furnished to the government of the foreign country where the recipient resides.

(ii) *Joint account holders.* In the case of joint account holders, a payor or middleman must report the entire amount of interest as paid to any joint account holder that provides a valid Form W-9, or, if any account holder has not furnished a Form W-8 or Form W-9, any account holder that is presumed to be a U.S. non-exempt recipient under §§1.6049-5(d)(2) and 1.1441-1(b)(3)(iii). If all of the joint account holders are foreign persons, then the payor or middleman must report the payment to the nonresident alien individual that is a resident of a country with which the United States has an income tax treaty or a tax information exchange agreement. If more than one of the joint account holders is a foreign person and is a resident of a country with which the United States has an income tax treaty or a tax information exchange agreement,

then the payor or middleman may report the interest as paid to any such account holder that is treated as the primary account holder under §31.3406(h)-2(a). If, however, any account holder requests its own Form 1042-S, the payor or middleman must furnish a Form 1042-S to the account holder who requests it.

(5) *Effective date.* This paragraph (e)(4) is effective for payee statements due after December 31 of the year in which the final regulations are published in the **Federal Register**, without regard to extensions. * * * (For interest paid to a Canadian nonresident alien individual on or before December 31 of the year in which final regulations are published in the **Federal Register**, see §1.6049-6(e)(4) as in effect and contained in 26 CFR part 1 revised April 1, 2000.)

* * * * *

Par. 4. In section 1.6049-8, the section heading and paragraph (a) are revised to read as follows:

§1.6049-8 Interest and original issue discount paid to nonresident alien individuals.

(a) *Interest subject to reporting requirement.* For purposes of §§1.6049-4, 1.6049-6, and this section and except as provided in paragraph (b) of this section, the term *interest* means interest paid to a nonresident alien individual after December 31 of the year in which the final regulations are published in the **Federal Register**, where the interest is described in section 871(i)(2)(A) with respect to a deposit maintained at an office within the United States. For purposes of the regulations under section 6049, a nonresident alien individual is a person described in section 7701(b)(1)(B). The payor or middleman may rely upon a valid Form W-8 to determine whether the payment is made to a nonresident alien individual. Generally, amounts described in this paragraph (a) are not subject to backup withholding under section 3406. See §31.3406(g)-1(d) of this chapter. However, if the payor or middleman does not have either a valid Form W-8 or valid Form W-9, the payor or middleman must report the payment as made to a U.S. non-exempt recipient if it must so treat the payee under the presumption rules of §1.6049-5(d)(2) and

§1.1441-1(b)(3)(iii) and must also backup withhold under section 3406. (For interest paid to a Canadian nonresident alien individual on or before December 31 of the year in which final regulations are published in the **Federal Register**, see §1.6049-8(a) as in effect and contained in 26 CFR part 1 revised April 1, 2000.)

* * * * *

PART 31 — EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Par. 5. The authority citation for part 31 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 6. In section 31.3406(g)-1, paragraph (d) is revised to read as follows:

§31.3406(g)-1 Exceptions for payments to certain payees and certain other payment.

* * * * *

(d) *Reportable payments made to nonresident alien individuals.* A payment of interest that is reported on Form 1042-S as paid to a nonresident alien individual under §1.6049-8(a) of this chapter is not subject to withholding under section 3406. (For interest paid to a Canadian nonresident alien individual on or before December 31 of the year in which final regulations are published in the **Federal Register**, see §31.3406(g)-1(d) as in effect and contained in 26 CFR part 1 revised April 1, 2000.)

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

(Filed by the Office of the Federal Register on January 16, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 17, 2001, 66 F.R. 3925)

Notice of Proposed Rulemaking and Notice of Public Hearing

Required Distributions From Retirement Plans

REG-130477-00;
REG-130481-00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to required minimum distributions from qualified plans, individual retirement plans, deferred compensation plans under section 457, and section 403(b) annuity contracts, custodial accounts, and retirement income accounts. These regulations will provide the public with guidance necessary to comply with the law and will affect administrators of, participants in, and beneficiaries of qualified plans; institutions that sponsor and individuals who administer individual retirement plans, individuals who use individual retirement plans for retirement income, and beneficiaries of individual retirement plans; and employees for whom amounts are contributed to section 403(b) annuity contracts, custodial accounts, or retirement income accounts and beneficiaries of such contracts and accounts.

DATES: Written and electronic comments must be received by April 19, 2001. Outlines of topics to be discussed at the public hearing scheduled for June 1, 2001, at 10 a.m. must be received by May 11, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG-130477-00/REG-130481-00) room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG-130477-00/REG-130481-00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.gov/tax_regs/reglist.html. The public hearing on June 1, 2001, will be held in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Cathy A. Vohs, 202-622-6090; concerning submissions and the hearing, and/or to be placed on the building access list to attend

the hearing, Guy Traynor, 202-622-7180 (not toll-free numbers).

Paperwork Reduction Act

The collections of information contained in these proposed regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-0996, in conjunction with the notice of proposed rulemaking published on July 27, 1987, 52 F.R. 28070, REG-EE-113-82, Required Distributions From Qualified Plans and Individual Retirement Plans, and control number 1545-1573, in conjunction with the notice of proposed rulemaking published on December 30, 1997, 62 F.R. 67780, REG-209463-82 (1998-1 C.B. 376), Required Distributions from Qualified Plans and Individual Retirement Plans.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books and records relating to the collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) and to the Pension Excise Tax Regulations (26 CFR Part 54) under sections 401, 403, 408, and 4974 of the Internal Revenue Code of 1986. It is contemplated that proposed rules similar to those in these proposed regulations applicable to section 401 will be published in the near future for purposes of applying the distribution requirements of section 457(d). These amendments are proposed to conform the regulations to section 1404 of the Small Business Job Protection Act of 1996 (SBJPA) (110 Stat. 1791), sections 1121 and 1852 of the Tax Reform Act of 1986 (TRA of 1986) (100 Stat. 2464 and 2864), sections 521 and 713 of the Tax Reform Act of 1984 (TRA

of 1984) (98 Stat. 865 and 955), and sections 242 and 243 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (96 Stat. 521). The regulations provide guidance on the required minimum distribution requirements under section 401(a)(9) for plans qualified under section 401(a). The rules are incorporated by reference in section 408(a)(6) and (b)(3) for individual retirement accounts and annuities (IRAs), section 408A(c)(5) for Roth IRAs, section 403(b)(10) for section 403(b) annuity contracts, and section 457(d) for eligible deferred compensation plans.

For purposes of this discussion of the background of the regulations in this preamble, as well as the explanation of provisions below, whenever the term *employee* is used, it is intended to include not only an employee but also an IRA owner.

Section 401(a)(9) provides rules for distributions during the life of the employee in section 401(a)(9)(A) and rules for distributions after the death of the employee in section 401(a)(9)(B). Section 401(a)(9)(A)(ii) provides that the entire interest of an employee in a qualified plan must be distributed, beginning not later than the employee's required beginning date, in accordance with regulations, over the life of the employee or over the lives of the employee and a designated beneficiary (or over a period not extending beyond the life expectancy of the employee and a designated beneficiary).

Section 401(a)(9)(C) defines required beginning date for employees (other than 5-percent owners and IRA owners) as April 1 of the calendar year following the later of the calendar year in which the employee attains age 70 1/2 or the calendar year in which the employee retires. For 5-percent owners and IRA owners, the required beginning date is April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2, even if the employee has not retired.

Section 401(a)(9)(D) provides that (except in the case of a life annuity) the life expectancy of an employee and the employee's spouse that is used to determine the period over which payments must be made may be redetermined, but not more frequently than annually.

Section 401(a)(9)(E) provides that the term *designated beneficiary* means any

individual designated as a beneficiary by the employee.

Section 401(a)(9)(G) provides that any distribution required to satisfy the incidental death benefit requirement of section 401(a) is a required minimum distribution.

Section 401(a)(9)(B)(i) provides that, if the employee dies after distributions have begun, the employee's interest must be distributed at least as rapidly as under the method used by the employee.

Section 401(a)(9)(B)(ii) and (iii) provides that, if the employee dies before required minimum distributions have begun, the employee's interest must be either: distributed (in accordance with regulations) over the life or life expectancy of the designated beneficiary with the distributions beginning no later than 1 year after the date of the employee's death, or distributed within 5 years after the death of the employee. However, under section 401(a)(9)(B)(iv), a surviving spouse may wait until the date the employee would have attained age 70 1/2 to begin taking required minimum distributions.

Comprehensive proposed regulations under section 401(a)(9) were previously published in the **Federal Register** on July 27, 1987, 52 F.R. 28070. Many of the comments on the 1987 proposed regulations expressed concerns that the required minimum distribution must be satisfied separately for each IRA owned by an individual by taking distributions from each IRA. In response, Notice 88-38 (1988-1 C.B. 524) provided that the amount of the required minimum distribution must be calculated for each IRA, but permitted that amount to be taken from any IRA. Amendments to the 1987 proposed regulations published in the **Federal Register** on December 30, 1997, 62 F.R. 67780, responded to comments on the use of trusts as beneficiaries. Notice 96-67 (1996-2 C.B. 235) and Notice 97-75 (1997-2 C.B. 337) provided guidance on the changes made to section 401(a)(9) by the SBJPA. The guidance in Notice 88-38, Notice 96-67, and Notice 97-75 is incorporated in these proposed regulations with some modifications.

Even though the distribution requirements added by TEFRA were retroactively repealed by TRA of 1984, the transition election rule in section 242(b) of TEFRA

was preserved. Notice 83-23 (1983-2 C.B. 418) continues to provide guidance for distributions permitted by this transition election rule. These proposed regulations retain the additional guidance on the transition rule provided in the 1987 proposed regulations.

As discussed below, in response to extensive comments, the rules for calculating required minimum distributions from individual accounts under the 1987 proposed regulations have been substantially simplified. Certain other 1987 rules have also been simplified and modified, although many of the 1987 rules remain unchanged. In particular, due to the relatively small number of comments on practices with respect to annuity contracts, and the effect of the 1987 proposed regulations on these practices, the basic structure of the 1987 proposed regulation provisions with respect to annuity payments is retained in these proposed regulations. The IRS and Treasury are continuing to study these rules and specifically request updated comments on current practices and issues relating to required minimum distributions from annuity contracts.

Explanation of Provisions

Overview

Many of the comments on the 1987 proposed regulations addressed the rules for required minimum distributions during an employee's life, including calculation of life expectancy and determination of designated beneficiary. In particular, comments raised concerns about the default provisions, election requirements, and plan language requirements. In general, the need to make decisions at age 70 1/2, which under the 1987 proposed regulations would bind the employee in future years during which financial circumstances could change significantly, was perceived as unreasonably restrictive. In addition, the determination of life expectancy and designated beneficiary and the resulting required minimum distribution calculation for individual accounts were viewed as too complex.

To respond to these concerns, these proposed regulations would make it much easier for individuals — both plan participants and IRA owners — and plan administrators to understand and apply the minimum distribution rules. The new

proposed regulations would make major simplifications to the rules, including the calculation of the required minimum distribution during the individual's lifetime and the determination of a designated beneficiary for distributions after death. The new proposed regulations simplify the rules by

- Providing a simple, uniform table that all employees can use to determine the minimum distribution required during their lifetime. This makes it far easier to calculate the required minimum distribution because employees would
 - no longer need to determine their beneficiary by their required beginning date,
 - no longer need to decide whether or not to recalculate their life expectancy each year in determining required minimum distributions, and
 - no longer need to satisfy a separate incidental death benefit rule.
- Permitting the required minimum distribution during the employee's lifetime to be calculated without regard to the beneficiary's age (except when required distributions can be reduced by taking into account the age of a beneficiary who is a spouse more than 10 years younger than the employee).
- Permitting the beneficiary to be determined as late as the end of the year following the year of the employee's death. This allows
 - the employee to change designated beneficiaries after the required beginning date without increasing the required minimum distribution and
 - the beneficiary to be changed after the employee's death, such as by one or more beneficiaries disclaiming or being cashed out.
- Permitting the calculation of post-death minimum distributions to take into account an employee's remaining life expectancy at the time of death, thus allowing distributions in all cases to be spread over a number of years after death.

These simplifications would also have the effect of reducing the required minimum distributions for the vast majority of employees.

The uniform distribution period

Under these proposed regulations and the 1987 proposed regulations, for distributions from an individual account, the required minimum distribution is determined by dividing the account balance by the distribution period. For lifetime required minimum distributions, these proposed regulations provide a uniform distribution period for all employees of the same age. The uniform distribution period table is the required minimum distribution incidental benefit (MDIB) divisor table originally prescribed in §1.401(a)(9)-2 of the 1987 proposed regulations and now included in A-4 of §1.401(a)(9)-5 of the new proposed regulations. An exception applies if the employee's sole beneficiary is the employee's spouse and the spouse is more than 10 years younger than the employee. In that case, the employee is permitted to use the longer distribution period measured by the joint life and last survivor life expectancy of the employee and spouse.

These changes provide a simple administrable rule for plans and individuals. Using the MDIB table, most employees will be able to determine their required minimum distribution for each year based on nothing more than their current age and their account balance as of the end of the prior year (which IRA trustees report annually to IRA owners). Under the 1987 proposed regulations, some employees already use the MDIB table to determine required minimum distributions. Under the new proposed regulations, they would continue to do so. For the majority of other employees, required minimum distributions would be reduced as a result of the changes.

For years after the year of the employee's death, the distribution period is generally the remaining life expectancy of the designated beneficiary. The beneficiary's remaining life expectancy is calculated using the age of the beneficiary in the year following the year of the employee's death, reduced by one for each subsequent year. If the employee's spouse is the employee's sole beneficiary at the end of the year following the year of death, the distribution period during the spouse's life is the spouse's single life expectancy. For years after the year of the spouse's death, the distribution period is the spouse's life expectancy calculated in the year of death, reduced by one for each subsequent year.

If there is no designated beneficiary as of the end of the year after the employee's death, the distribution period is the employee's life expectancy calculated in the year of death, reduced by one for each subsequent year.

The MDIB table is based on the joint life expectancies of an individual and a survivor 10 years younger at each age beginning at age 70. Allowing the use of this table reflects the fact that an employee's beneficiary is subject to change until the death of the employee and ultimately may be a beneficiary more than 10 years younger than the employee. The proposed regulations would allow lifetime distributions at a rate consistent with this possibility. Consistent with the requirements of section 401(a)(9)(A)(ii), the distribution period after death is measured by the life expectancy of the employee's designated beneficiary in the year following death, or the employee's remaining life expectancy if there is no designated beneficiary. This ensures that the employee's entire benefit is distributed over a period described in section 401(a)(9)(A)(ii), i.e., the life expectancy of the employee or the joint life expectancy of the employee and a designated beneficiary.

The approach in these proposed regulations allowing the use of a uniform lifetime distribution period addresses concerns raised in comments on the 1987 proposed regulations that the rules are too complex. It eliminates the use of two tables and the interaction of the multiple beneficiary and change in beneficiary rules. Finally, it generally eliminates the need to fix the amount of the distribution during the employee's lifetime based on the beneficiary designated on the required beginning date and eliminates the need to elect recalculation or no recalculation of life expectancies at the required beginning date.

Suggestions have been received that the life expectancy table used to calculate required minimum distributions should be revised to reflect recent increases in longevity. These proposed regulations instead provide authority for the Commissioner to issue guidance of general applicability revising the life expectancy tables and the uniform distribution table in the future if it becomes appropriate. While life expectancy has increased in the 14 years since the issuance of the section 72

life expectancy tables, those tables may already overstate the average life expectancy of the class of individuals who are subject to these required minimum distribution rules (qualified plan participants, IRA owners, *et al.*). That is because those existing section 72 tables were derived from the particular mortality experience of the select population of individuals who purchase individual annuities, as opposed to the population who are subject to the required minimum distribution rules. In any event, as noted earlier, the new proposed uniform distribution period—equal to the joint life expectancy of an individual and a survivor 10 years younger at each age—would lengthen the lifetime distribution period for most employees and beneficiaries. In fact, the new proposed regulations would lengthen that period more for many individuals than would an update to reflect recent increases in longevity. The IRS and Treasury believe that this lengthening of the distribution period for most employees provides further justification for retaining the existing life expectancy tables at this time.

Some commentators suggested that the calculation of required minimum distributions include credit for any distribution in a prior year that exceeded that year's required minimum distribution. However, such a "credit" carryforward would require significant additional data retention and would add substantial complexity to the calculation of required minimum distributions. By using the prior year's ending account balance for calculating required minimum distributions, distribution of amounts in excess of the required minimum distribution has the effect of reducing future required minimum distributions over the remaining distribution period to some extent. Accordingly, these proposed regulations do not provide for a credit carryforward.

Determination of the designated beneficiary

These proposed regulations provide that, generally, the designated beneficiary is determined as of the end of the year following the year of the employee's death rather than as of the employee's required beginning date or date of death, as under the 1987 proposed regulations. Thus, any beneficiary eliminated by distribution of

the benefit or through disclaimer (or otherwise) during the period between the employee's death and the end of the year following the year of death is disregarded in determining the employee's designated beneficiary for purposes of calculating required minimum distributions. If, as of the end of the year following the year of the employee's death, the employee has more than one designated beneficiary and the account or benefit has not been divided into separate accounts or shares for each beneficiary, the beneficiary with the shortest life expectancy is the designated beneficiary, consistent with the approach in the 1987 proposed regulations.

This approach for determining the designated beneficiary following the death of an employee after the employee's required beginning date is simpler in several respects than the approach in the 1987 proposed regulations and responds to concerns raised with respect to the effects of beneficiary designation at the required beginning date. Under this approach, the determination of the designated beneficiary and the calculation of the beneficiary's life expectancy generally are contemporaneous with commencement of required distributions to the beneficiary. Any prior beneficiary designation is irrelevant for distributions from individual accounts, unless the employee takes advantage of a lifetime distribution period measured by the joint life expectancy of the employee and a spouse more than 10 years younger than the employee. Further, for an employee with a designated beneficiary, this approach provides the same rules for distributions after the employee's death, regardless of whether death occurs before or after an employee's required beginning date. Finally, in the case of an employee who elects or defaults into recalculation of life expectancy and who dies without a designated beneficiary, the requirement that the employee's entire remaining account balance be distributed in the year after an employee's death has been eliminated and replaced with a distribution period equal to the employee's remaining life expectancy recalculated immediately before death.

Default rule for post-death distributions

As requested by some commentators, these proposed regulations would change

the default rule in the case of death before the employee's required beginning date for a nonspouse designated beneficiary from the 5-year rule in section 401(a)(9)(B)(ii) to the life expectancy rule in section 401(a)(9)(B)(iii). Thus, absent a plan provision or election of the 5-year rule, the life expectancy rule would apply in all cases in which the employee has a designated beneficiary. As in the case of death on or after the employee's required beginning date, the designated beneficiary whose life expectancy is used to determine the distribution period would be determined as of the end of the year following the year of the employee's death, rather than as of the employee's date of death (as would have been required under the 1987 proposed regulations). The 5-year rule would apply automatically only if the employee did not have a designated beneficiary as of the end of the year following the year of the employee's death. Finally, in the case of death before the employee's required beginning date, these proposed regulations allow a waiver, unless the Commissioner determines otherwise, of any excise tax resulting from the life expectancy rule during the first five years after the year of the employee's death if the employee's entire benefit is distributed by the end of the fifth year following the year of the employee's death.

Annuity payments

These proposed regulations make several changes to the rules for determining whether annuity payments satisfy section 401(a)(9). The changes are designed to make these rules more administrable without adverse effects on the basic structure and application of the rules. The IRS and Treasury are continuing to study and evaluate whether additional changes would be appropriate for determining whether annuity payments satisfy section 401(a)(9). Some comments were received on the annuity rules in 1987, but updated comments that include a discussion of current industry practices, products, and concerns would be helpful.

These proposed regulations provide that the designated beneficiary for determining the distribution period for annuity payments generally is the beneficiary as of the annuity starting date, even if that date is after the required beginning date. Thus, if annuity payments commence

after the required beginning date, the termination of the designated beneficiary is contemporaneous with the annuity starting date and any intervening changes in the beneficiary designation since the required beginning date are ignored. Second, as requested in comments, these regulations extend to all annuity payment streams the rule in the 1987 proposed regulations that allows a life annuity with a period certain not exceeding 20 years to commence on the required beginning date with no makeup for the first distribution calendar year. For this purpose, the regulations clarify that only accruals as of the end of the prior calendar year must be taken into account in calculating the amount of an annuity commencing on the required beginning date. Subsequent accruals are treated as additional accruals that must be taken into account in the next calendar year. Also as requested in comments, the regulations provide that, although additional accruals need to be taken into account in the first payment in the calendar year following the year of the accrual, actual payment in the form of a make-up payment need only be completed by the end of that calendar year.

The permitted increase in annuity payments to an employee upon the death of the survivor annuitant has been expanded to cover the elimination of the survivor portion of a joint and survivor annuity due to a qualified domestic relations order. Further, in response to comments, in the case of an annuity contract purchased from an insurance company, an exception to the nonincreasing-payment requirement in these proposed regulations has been added to accommodate a cash refund upon the employee's death of the amount of the premiums paid for the contract.

One of the rules in the 1987 proposed regulations that the IRS and Treasury are continuing to study and evaluate is the rule providing that if the distributions from a defined benefit plan are not in the form of an annuity, the employee's benefit will be treated as an individual account for purposes of determining required minimum distributions. The IRS and Treasury are continuing to consider whether retention of this rule is appropriate for defined benefit plans. Similarly, the IRS and Treasury are continuing to consider whether the rule permitting the benefit under a defined benefit plan to be divided

into segregated shares for purposes of section 401(a)(9) is useful and appropriate for defined benefit plans.

Trust as beneficiary

These proposed regulations retain the provision in the proposed regulations, as amended in 1997, allowing an underlying beneficiary of a trust to be an employee's designated beneficiary for purposes of determining required minimum distributions when the trust is named as the beneficiary of a retirement plan or IRA, provided that certain requirements are met. One of these requirements is that documentation of the underlying beneficiaries of the trust be provided timely to the plan administrator. In the case of individual accounts, unless the lifetime distribution period for an employee is measured by the joint life expectancy of the employee and the employee's spouse, the deadline under these proposed regulations for providing the beneficiary documentation would be the end of the year following the year of the employee's death. This is consistent with the deadline for determining the employee's designated beneficiary. Because the designated beneficiary during an employee's lifetime is not relevant for determining lifetime required minimum distributions in most cases under these proposed regulations, the burden of lifetime documentation requirements contained in the previous proposed regulations is significantly reduced.

A significant number of commentators on the 1997 amendment to the proposed regulations requested clarification that a testamentary trust named as an employee's beneficiary is a trust that qualifies for the look-through rule to the underlying beneficiaries, as permitted in the 1997 proposed regulations. These proposed regulations provide examples in which a testamentary trust is named as an employee's beneficiary and the look-through trust rules apply. As previously illustrated in the facts of Rev. Rul. 2000-2, 2000-3 I.R.B. 305, the examples also clarify that remaindermen of a "QTIP" trust must be taken into account as beneficiaries in determining the distribution period for required minimum distributions if amounts are accumulated for their benefit during the life of the income beneficiary under the trust.

These proposed regulations retain the basic rules in the 1987 proposed regulation for a qualified domestic relations order (QDRO). Thus, for example, the proposed regulations continue to provide that a former spouse to whom all or a portion of the employee's benefit is payable pursuant to a QDRO will be treated as a spouse (including a surviving spouse) of the employee for purposes of section 401(a)(9), including the minimum distribution incidental benefit requirement, regardless of whether the QDRO specifically provides that the former spouse is treated as the spouse for purposes of sections 401(a)(11) and 417. This rule applies regardless of the number of former spouses an employee has who are alternate payees with respect to the employee's retirement benefits. Further, for example, if a QDRO divides the individual account of an employee in a defined contribution plan into a separate account for the employee and a separate account for the alternate payee, the required minimum distribution to the alternate payee during the lifetime of the employee must nevertheless be determined using the same rules that apply to distribution to the employee. Thus, required minimum distributions to the alternate payee must commence by the employee's required beginning date. However, the required minimum distribution for the alternate payee will be separately determined. The required minimum distributions for the alternate payee during the lifetime of the employee may be determined either using the uniform distribution period discussed above based on the age of the employee in the distribution calendar year, or, if the alternate payee is the employee's former spouse and is more than 10 years younger than the employee, using the joint life expectancy of the employee and the alternate payee.

Election of surviving spouse to treat an inherited IRA as spouse's own IRA

These proposed regulations clarify the rule in the 1987 proposed regulations that allows the surviving spouse of a decedent IRA owner to elect to treat an IRA inherited by the surviving spouse from that

owner as the spouse's own IRA. The 1987 proposed regulations provide that this election is deemed to have been made if the surviving spouse contributes to the IRA or does not take the required minimum distribution for a year under section 401(a)(9)(B) as a beneficiary of the IRA. These new proposed regulations clarify that this deemed election is permitted to be made only after the distribution of the required minimum amount for the account, if any, for the year of the individual's death. Further these new proposed regulations clarify that this deemed election is permitted only if the spouse is the sole beneficiary of the account and has an unlimited right to withdrawal from the account. This requirement is not satisfied if a trust is named as beneficiary of the IRA, even if the spouse is the sole beneficiary of the trust. These clarifications make the election consistent with the underlying premise that the surviving spouse could have received a distribution of the entire decedent IRA owner's account and rolled it over to an IRA established in the surviving spouse's own name as IRA owner.

These new proposed regulations also clarify that, except for the required minimum distribution for the year of the individual's death, the spouse is permitted to roll over the post-death required minimum distribution under section 401(a)(9)(B) for a year if the spouse is establishing the IRA rollover account in the name of the spouse as IRA owner. However, if the surviving spouse is age 70 1/2 or older, the minimum lifetime distribution required under section 401(a)(9)(A) must be made for the year and, because it is a required minimum distribution, that amount may not be rolled over. These proposed regulations provide that this election by a surviving spouse eligible to treat an IRA as the spouse's own may also be accomplished by redesignating the IRA with the name of the surviving spouse as owner rather than beneficiary.

IRA reporting of required minimum distributions

Because these regulations substantially simplify the calculation of required minimum distributions from IRAs, IRA trustees, custodians, and issuers determining the account balance as of the end of the year can also calculate the following

year's required minimum distribution for each IRA. To improve compliance and further reduce the burden imposed on IRA owners and beneficiaries, under the authority provided in section 408(i), these proposed regulations would require the trustee, custodian, or issuer of each IRA to report the amount of the required minimum distribution from the IRA to the IRA owner or beneficiary and to the IRS at the time and in the manner provided under IRS forms and instructions. This reporting would be required regardless of whether the IRA owner is planning to take the required minimum distribution from that IRA or from another IRA, and would indicate that the IRA owner is permitted to take the required minimum distribution from any other IRA of the owner. During year 2001, the IRS will be receiving public comments and consulting with interested parties to assist the IRS in evaluating what form best accommodates this reporting requirement, what timing is appropriate (e.g., the beginning of the calendar year for which the required amount is being calculated), and what effective date would be most appropriate for the reporting requirement. In this context, after thorough consideration of comments and consultation with interested parties, the IRS intends to develop procedures and a schedule for reporting that provides adequate lead time, and minimizes the reporting burden, for IRA trustees, issuers, and custodians in complying with this new reporting requirement while providing the most useful information to the IRA owners and beneficiaries.

The IRS and Treasury are also considering whether similar reporting would be appropriate for section 403(b) contracts.

Permitted Delays Relative to QDROs and State Insurer Delinquency Proceedings

The regulations permit the required minimum distribution for a year to be delayed to a later year in certain circumstances. Specifically, commentators requested a delay during a period of up to 18 months during which an amount is segregated in connection with the review of a domestic relations order pursuant to section 414(p)(7). Commentators also requested that a delay be permitted while annuity payments under an annuity contract issued by a life insurance company in state insurer delinquency proceedings

have been reduced or suspended by reason of state proceedings. These proposed regulations allow delay in these circumstances.

Correction of failures under section 401(a)(9)

The proposed regulations do not set forth the special rule relieving a plan from disqualification for isolated instances of failure to satisfy section 401(a)(9) because all failures for qualified plans and section 403(b) accounts under section 401(a)(9) are now permitted to be corrected through the Employee Plans Compliance Resolution System (EPCRS). See Rev. Proc. 2000-16 (2000-6 I.R.B. 518).

Amendment of Qualified Plans

These regulations are proposed to be effective for distributions for calendar years beginning on or after January 1, 2002. For distributions for calendar years beginning before the effective date of final regulations, plan sponsors can continue to rely on the 1987 proposed regulations, to the extent those proposed regulations are not inconsistent with the changes to section 401(a)(9) made by the Small Business Job Protection Act of 1996 (SBJPA) and guidance related to those changes. Alternatively, for distributions for the 2001 and subsequent calendar years beginning before the effective date of final regulations, plan sponsors are permitted, but not required, to follow these proposed regulations in the operation of their plans by adopting the model amendment set forth below.

The Treasury Department and the IRS are making the model amendment set forth below available to plan sponsors to permit them to apply these proposed regulations in the operation of their plans without violating the requirement that a plan be operated in accordance with its terms. Plan sponsors who adopt the model amendment will have reliance that, during the term of the amendment, operation of their plans in a manner that satisfies the minimum distribution requirements in these proposed regulations will not cause their plans to fail to be qualified. In addition, distributees will have reliance that distributions that are made during the term of the amendment that satisfy the minimum distribution requirements in these proposed regulations. The model

amendment may be adopted by plan sponsors, practitioners who sponsor volume submitter specimen plans and sponsors of master and prototype (M&P) plans.

These proposed regulations permit plans to make distributions under either default provisions or under permissible optional provisions. A plan that has been amended by adoption of the model amendment will be treated as operating in conformance with a requirement of the proposed regulations that permits the use of either default or optional provisions if the plan is operated consistently in accordance with either the default rule or a specific permitted alternative, notwithstanding the plan's terms.

The Service will not issue determination, opinion or advisory letters on the basis of the changes in these proposed regulations until the publication of final regulations. Until such time, the IRS will continue to issue such letters on the basis of the 1987 proposed regulations and SBJPA. Although the IRS will not issue determination, opinion or advisory letters with respect to the model amendment, the adoption of the model amendment will not affect a determination letter issued for a plan whose terms otherwise satisfy the 1987 proposed regulations and SBJPA. Plan sponsors should not adopt other amendments to attempt to conform their plans to the changes in these proposed regulations before the publication of final regulations. The IRS intends to publish procedures at a later date that will allow qualified plans to be amended to reflect the regulations under section 401(a)(9) when they are finalized.

Qualified plans are required to be amended for changes in the plan qualification requirements made by GUST by the end of the GUST remedial amendment period under section 401(b), which is generally the end of the first plan year beginning on or after January 1, 2001, or, if applicable, a later date determined under the provisions of section 19 of Rev. Proc. 2000-20 (2000-6 I.R.B. 553). Many plans have been operated in a manner that reflects the changes to section 401(a)(9) made by SBJPA and will have to be amended for these changes by the end of the GUST remedial amendment period. The IRS intends that its procedures for amending qualified plans for the final regulations under section

401(a)(9) will generally avoid the need for plan sponsors, volume submitter practitioners and M&P plan sponsors to request another determination, opinion or advisory letter subsequent to their application for a GUST letter. In addition, to the extent such a subsequent letter is needed or desired, the IRS intends that its procedures will provide that the application for the letter will not have to be submitted prior to the next time the plan is otherwise amended or required to be amended.

The model amendment described above is set forth below:

“With respect to distributions under the Plan made for calendar years beginning on or after January 1, 2001 (ALTERNATIVELY, SPECIFY A LATER CALENDAR YEAR FOR WHICH THE AMENDMENT IS TO BE INITIALLY EFFECTIVE), the Plan will apply the minimum distribution requirements of section 401(a)(9) of the Internal Revenue Code in accordance with the regulations under section 401(a)(9) that were proposed in January 2001, notwithstanding any provision of the Plan to the contrary. This amendment shall continue in effect until the end of the last calendar year beginning before the effective date of final regulations under section 401(a)(9) or such other date as may be specified in guidance published by the Internal Revenue Service.”

Amendment of IRAs and Effective Date

These regulations are proposed to be effective for distributions for calendar years beginning on or after January 1, 2002. For distributions for the 2001 calendar year, IRA owners are permitted, but not required, to follow these proposed regulations in operation, notwithstanding the terms of the IRA documents. IRA owners may therefore rely on these proposed regulations for distributions for the 2001 calendar year. However, IRA sponsors should not amend their IRA documents to conform their IRAs to the changes in these proposed regulations before the publication of final regulations. The IRS will not issue model IRAs on the basis of the changes in these proposed regulations until the publication of final regulations. Until such time, IRA owners

can continue to use the current model IRAs which are based on the 1987 proposed regulations under section 401(a)(9). The IRS will publish procedures at a later date that will allow IRAs to be amended to reflect final regulations under section 401(a)(9).

Proposed Effective Date

The regulations are proposed to be applicable for determining required minimum distributions for calendar years beginning on or after January 1, 2002. For determining required minimum distributions for calendar year 2001, taxpayers may rely on these proposed regulations or on the 1987 proposed regulations. If, and to the extent, future guidance is more restrictive than the guidance in these proposed regulations, the future guidance will be issued without retroactive effect.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that, when determining the minimum required distribution in cases where a plan participant wishes to designate a trust as beneficiary of the participant's benefit, the reporting burden is primarily on the plan participant, or trustee of the trust named as beneficiary, to supply information rather than on the entity maintaining the retirement plan and the fact that the number of participants per plan to whom the burden applies is insignificant. The recordkeeping burden with respect to section 403(b) contracts under the pre-1987 account balance must be maintained only applies to issuers and custodians of those contracts, which generally are not small entities. Accordingly, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. In addition to the other requests for comments set forth in this document, the IRS and Treasury also request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for June 1, 2001, at 10 a.m. in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by May 11, 2001.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Marjorie Hoffman and Cathy A. Vohs of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in their development.

* * * * *

Adoption of Amendments of the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§1.401(a)(9)–1 is also issued under 26 U.S.C. 401(a)(9).

§1.401(a)(9)–2 is also issued under 26 U.S.C. 401(a)(9).

§1.401(a)(9)–3 is also issued under 26 U.S.C. 401(a)(9).

§1.401(a)(9)–4 is also issued under 26 U.S.C. 401(a)(9).

§1.401(a)(9)–5 is also issued under 26 U.S.C. 401(a)(9).

§1.401(a)(9)–6 is also issued under 26 U.S.C. 401(a)(9).

§1.401(a)(9)–7 is also issued under 26 U.S.C. 401(a)(9).

§1.401(a)(9)–8 is also issued under 26 U.S.C. 401(a)(9). * * *

§1.403(b)–2 is also issued under 26 U.S.C. 403(b)(10). * * *

§1.408–8 is also issued under 26 U.S.C. 408(a)(6) and (b)(3). * * *

Par. 2. Sections 1.401(a)(9)–0 through 1.401(a)(9)–8 are added to read as follows:

§1.401(a)(9)–0 Required minimum distributions; table of contents.

This table of contents lists the regulations relating to required minimum distributions under section 401(a)(9) of the Internal Revenue Code as follows:

§1.401(a)(9)–0 Required minimum distributions; table of contents.

§1.401(a)(9)–1 Required minimum distribution requirement in general.

§1.401(a)(9)–2 Distributions commencing before an employee's death.

§1.401(a)(9)–3 Death before required beginning date.

§1.401(a)(9)–4 Determination of the designated beneficiary.

§1.401(a)(9)–5 Required minimum distributions from defined contribution plans.

§1.401(a)(9)–6 Required minimum distributions from defined benefit plans.

§1.401(a)(9)–7 Rollovers and transfers.

§1.401(a)(9)–8 Special rules.

§1.401(a)(9)–1 Required minimum distribution requirement in general.

Q-1. What plans are subject to the required minimum distribution requirement under section 401(a)(9) and §§1.401(a)(9)–1 through 1.401(a)(9)–8?

A-1. All stock bonus, pension, and profit-sharing plans qualified under section 401(a) and annuity contracts described in section 403(a) are subject to the required minimum distribution rules in section 401(a)(9) and §§1.401(a)(9)–1 through 1.401(a)(9)–8. See §1.403(b)–2 for the distribution rules applicable to annuity contracts or custodial accounts described in section 403(b), see §1.408–8 for the distribution rules applicable to individual retirement plans, see §1.408A–6 described for the distribution rules applicable to Roth IRAs under section 408A, and see section 457(d)(2)(A) for distribution rules applicable to certain deferred compensation plans for employees of tax exempt organizations or state and local government employees.

Q-2. Which employee account balances and benefits held under qualified trusts and plans are subject to the distribution rules of section 401(a)(9) and §§1.401(a)(9)–1 through 1.401(a)(9)–8?

A-2. The distribution rules of section 401(a)(9) apply to all account balances and benefits in existence on or after January 1, 1985. Sections 1.401(a)(9)–1 through 1.401(a)(9)–8 apply for purposes of determining required minimum distributions for calendar years beginning on or after January 1, 2002.

Q-3. What specific provisions must a plan contain in order to satisfy section 401(a)(9)?

A-3. (a) *Required provisions.* In order to satisfy section 401(a)(9), the plan must include several written provisions reflecting section 401(a)(9). First, the plan must generally set forth the statutory rules of section 401(a)(9), including the incidental death benefit requirement in section 401(a)(9)(G). Second, the plan must provide that distributions will be made in accordance with §§1.401(a)(9)–1 through 1.401(a)(9)–8. The plan document must also provide that the provisions reflecting section 401(a)(9) override any distribution options in the plan inconsistent with section 401(a)(9). The plan also must include any other provisions

reflecting section 401(a)(9) as are prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b) of this chapter.

(b) *Optional provisions.* The plan may also include written provisions regarding any optional provisions governing plan distributions that do not conflict with section 401(a)(9) and the regulations thereunder.

(c) *Absence of optional provisions.* Plan distributions commencing after an employee's death will be required to be made under the default provision set forth in §1.401(a)(9)–3 for distributions unless the plan document contains optional provisions that override such default provisions. Thus, if distributions have not commenced to the employee at the time of the employee's death, distributions after the death of an employee are to be made automatically in accordance with the default provisions in A-4(a) of §1.401(a)(9)–3 unless the plan either specifies in accordance with A-4(b) of §1.401(a)(9)–3 the method under which distributions will be made or provides for elections by the employee (or beneficiary) in accordance with A-4(c) of §1.401(a)(9)–3 and such elections are made by the employee or beneficiary.

§1.401(a)(9)–2 Distributions commencing before an employee's death.

Q-1. In the case of distributions commencing before an employee's death, how must the employee's entire interest be distributed in order to satisfy section 401(a)(9)(A)?

A-1. (a) In order to satisfy section 401(a)(9)(A), the entire interest of each employee must be distributed to such employee not later than the required beginning date, or must be distributed, beginning not later than the required beginning date, over the life of the employee or joint lives of the employee and a designated beneficiary or over a period not extending beyond the life expectancy of the employee or the joint life and last survivor expectancy of the employee and the designated beneficiary.

(b) Section 401(a)(9)(G) provides that lifetime distributions must satisfy the incidental death benefit requirements.

(c) The amount required to be distributed for each calendar year in order to sat-

isfy section 401(a)(9)(A) and (G) generally depends on whether a distribution is in the form of distributions under a defined contribution plan or annuity payments under a defined benefit plan. For the method of determining the required minimum distribution in accordance with section 401(a)(9)(A) and (G) from an individual account under a defined contribution plan, see §1.401(a)(9)–5. For the method of determining the required minimum distribution in accordance with section 401(a)(9)(A) and (G) in the case of annuity payments from a defined benefit plan or an annuity contract, see §1.401(a)(9)–6.

Q-2. For purposes of section 401(a)(9)(C), what does the term *required beginning date* mean?

A-2. (a) Except as provided in paragraph (b) of this A-2 with respect to a 5-percent owner, as defined in paragraph (c), the term *required beginning date* means April 1 of the calendar year following the later of the calendar year in which the employee attains age 70 1/2, or the calendar year in which the employee retires from employment with the employer maintaining the plan.

(b) In the case of an employee who is a 5-percent owner, the term *required beginning date* means April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2.

(c) For purposes of section 401(a)(9), a 5-percent owner is an employee who is a 5-percent owner (as defined in section 416) with respect to the plan year ending in the calendar year in which the employee attains age 70 1/2.

(d) Paragraph (b) of this A-2 does not apply in the case of a governmental plan (within the meaning of section 414(d)) or a church plan. For purposes of this paragraph, the term *church plan* means a plan maintained by a church for church employees, and the term *church* means any church (as defined in section 3121(w)(3)(A)) or qualified church-controlled organization (as defined in section 3121(w)(3)(B)).

(e) A plan is permitted to provide that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which the employee attained age 70 1/2 regardless of whether the employee is a 5-percent owner.

Q-3. When does an employee attain age 70 1/2?

A-3. An employee attains age 70 1/2 as of the date six calendar months after the 70th anniversary of the employee's birth. For example, if an employee's date of birth was June 30, 1932, the 70th anniversary of such employee's birth is June 30, 2002. Such employee attains age 70 1/2 on December 30, 2002. Consequently, if the employee is a 5-percent owner or retired, such employee's required beginning date is April 1, 2003. However, if the employee's date of birth was July 1, 1932, the 70th anniversary of such employee's birth would be July 1, 2002. Such employee would then attain age 70 1/2 on January 1, 2003, and such employee's required beginning date would be April 1, 2004.

Q-4. Must distributions made before the employee's required beginning date satisfy section 401(a)(9)?

A-4. Lifetime distributions made before the employee's required beginning date for calendar years before the employee's first distribution calendar year, as defined in A-1(b) of §1.401(a)(9)-5, need not be made in accordance with section 401(a)(9). However, if distributions commence before the employee's required beginning date under a particular distribution option, such as in the form of an annuity, the distribution option fails to satisfy section 401(a)(9) at the time distributions commence if, under terms of the particular distribution option, distributions to be made for the employee's first distribution calendar year or any subsequent distribution calendar year will fail to satisfy section 401(a)(9).

Q-5. If distributions have begun to an employee before the employee's death (in accordance with section 401(a)(9)(A)(ii)), how must distributions be made after an employee's death?

A-5. Section 401(a)(9)(B)(i) provides that if the distribution of the employee's interest has begun in accordance with section 401(a)(9)(A)(ii) and the employee dies before his entire interest has been distributed to him, the remaining portion of such interest must be distributed at least as rapidly as under the distribution method being used under section 401(a)(9)(A)(ii) as of the date of his death. The amount required to be distributed for each distribution calendar

year following the calendar year of death generally depends on whether a distribution is in the form of distributions from an individual account under a defined contribution plan or annuity payments under a defined benefit plan. For the method of determining the required minimum distribution in accordance with section 401(a)(9)(B)(i) from an individual account, see A-5(a) of §1.401(a)(9)-5 for the calculation of the distribution period that applies when an employee dies after the employee's required beginning date. In the case of annuity payments from a defined benefit plan or an annuity contract, see §1.401(a)(9)-6.

Q-6. For purposes of section 401(a)(9)(B), when are distributions considered to have begun to the employee in accordance with section 401(a)(9)(A)(ii)?

A-6. (a) *General rule.* Except as otherwise provided in A-10 of §1.401(a)(9)-6, distributions are not treated as having begun to the employee in accordance with section 401(a)(9)(A)(ii) until the employee's required beginning date, without regard to whether payments have been made before that date. For example, if employee A upon retirement in 2002, the calendar year A attains age 65 1/2, begins receiving installment distributions from a profit-sharing plan over a period not exceeding the joint life and last survivor expectancy of A and A's beneficiary, benefits are not treated as having begun in accordance with section 401(a)(9)(A)(ii) until April 1, 2008 (the April 1 following the calendar year in which A attains age 70 1/2). Consequently, if such employee dies before April 1, 2008 (A's required beginning date), distributions after A's death must be made in accordance with section 401(a)(9)(B)(ii) or (iii) and (iv) and §1.401(a)(9)-3, and not section 401(a)(9)(B)(i). This is the case without regard to whether the plan has distributed the minimum distribution for the first distribution calendar year (as defined in A-1(b) of §1.401(a)(9)-5) before A's death.

(b) If a plan provides, in accordance with A-2(e) of this section, that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2, an employee who dies after the required beginning date deter-

mined under the plan terms is treated as dying after the employee's required beginning date for purposes of A-5(a) of this section even though the employee dies before the April 1 following the calendar year in which the employee retires.

§1.401(a)(9)-3 Death before required beginning date.

Q-1. If an employee dies before the employee's required beginning date, how must the employee's entire interest be distributed in order to satisfy section 401(a)(9)?

A-1. (a) Except as otherwise provided in A-10 of §1.401(a)(9)-6, if an employee dies before the employee's required beginning date (and, thus, generally before distributions are treated as having begun in accordance with section 401(a)(9)(A)(ii)), distribution of the employee's entire interest must be made in accordance with one of the methods described in section 401(a)(9)(B)(ii) or (iii). One method (the five-year rule in section 401(a)(9)(B)(ii)) requires that the entire interest of the employee be distributed within five years of the employee's death regardless of who or what entity receives the distribution. Another method (the life expectancy rule in section 401(a)(9)(B)(iii)) requires that any portion of an employee's interest payable to (or for the benefit of) a designated beneficiary be distributed, commencing within one year of the employee's death, over the life of such beneficiary (or over a period not extending beyond the life expectancy of such beneficiary). Section 401(a)(9)(B)(iv) provides special rules where the designated beneficiary is the surviving spouse of the employee, including a special commencement date for distributions under section 401(a)(9)(B)(iii) to the surviving spouse.

(b) See A-4 of this section for the rules for determining which of the methods described in paragraph (a) applies. See A-3 of this section to determine when distributions under the exception to the five-year rule in section 401(a)(9)(B)(iii) and (iv) must commence. See A-2 of this section to determine when the five-year period in section 401(a)(9)(B)(ii) ends. For distributions using the life expectancy rule in section 401(a)(9)(B)(iii) and (iv), see §1.401(a)(9)-4 in order to determine the designated beneficiary under section

401(a)(9)(B)(iii) and (iv), see §1.401(a)(9)–5 for the rules for determining the required minimum distribution under a defined contribution plan, and see §1.401(a)(9)–6 for required minimum distributions under defined benefit plans.

Q-2. By when must the employee's entire interest be distributed in order to satisfy the five-year rule in section 401(a)(9)(B)(ii)?

A-2. In order to satisfy the five-year rule in section 401(a)(9)(B)(ii), the employee's entire interest must be distributed by the end of the calendar year which contains the fifth anniversary of the date of the employee's death. For example, if an employee dies on January 1, 2002, the entire interest must be distributed by the end of 2007, in order to satisfy the five-year rule in section 401(a)(9)(B)(ii).

Q-3. When are distributions required to commence in order to satisfy the life expectancy rule in section 401(a)(9)(B)(iii) and (iv)?

A-3. (a) *Nonspouse beneficiary.* In order to satisfy the life expectancy rule in section 401(a)(9)(B)(iii), if the designated beneficiary is not the employee's surviving spouse, distributions must commence on or before the end of the calendar year immediately following the calendar year in which the employee died. This rule also applies to the distribution of the entire remaining benefit if another individual is a designated beneficiary in addition to the employee's surviving spouse. See A-2 and A-3 of §1.401(a)(9)–8, however, if the employee's benefit is divided into separate accounts (or segregated shares, in the case of a defined benefit plan).

(b) *Spousal beneficiary.* In order to satisfy the rule in section 401(a)(9)(B)(iii) and (iv), if the sole designated beneficiary is the employee's surviving spouse, distributions must commence on or before the later of -

(1) The end of the calendar year immediately following the calendar year in which the employee died; and

(2) The end of the calendar year in which the employee would have attained age 70 1/2.

Q-4. How is it determined whether the five-year rule in section 401(a)(9)(B)(ii) or the life expectancy rule in section 401(a)(9)(B)(iii) and (iv) applies to a distribution?

A-4. (a) *No plan provision.* If a plan does not adopt an optional provision described in paragraph (b) or (c) of this A-4 specifying the method of distribution after the death of an employee, distribution must be made as follows:

(1) If the employee has a designated beneficiary, as determined under §1.401(a)(9)–4, distributions are to be made in accordance with the life expectancy rule in section 401(a)(9)(B)(iii) and (iv).

(2) If the employee has no designated beneficiary, distributions are to be made in accordance with the five-year rule in section 401(a)(9)(B)(ii).

(b) *Optional plan provisions.* The plan may adopt a provision specifying either that the five-year rule in section 401(a)(9)(B)(ii) will apply to certain distributions after the death of an employee even if the employee has a designated beneficiary or that distribution in every case will be made in accordance with the five-year rule in section 401(a)(9)(B)(ii). Further, a plan need not have the same method of distribution for the benefits of all employees.

(c) *Elections.* A plan may adopt a provision that permits employees (or beneficiaries) to elect on an individual basis whether the five-year rule in section 401(a)(9)(B)(ii) or the life expectancy rule in section 401(a)(9)(B)(iii) and (iv) applies to distributions after the death of an employee who has a designated beneficiary. Such an election must be made no later than the earlier of, the end of the calendar year in which distribution would be required to commence in order to satisfy the requirements for the life expectancy rule in section 401(a)(9)(B)(iii) and (iv) (see A-3 of this section for the determination of such calendar year), or the end of the calendar year which contains the fifth anniversary of the date of death of the employee. As of the date determined under the life expectancy rule, the election must be irrevocable with respect to the beneficiary (and all subsequent beneficiaries) and must apply to all subsequent calendar years. If a plan provides for the election, the plan may also specify the method of distribution that applies if neither the employee nor the beneficiary makes the election. If neither the employee nor the beneficiary elects a method and the plan does not specify which method

applies, distribution must be made in accordance with paragraph (a).

Q-5. If the employee's surviving spouse is the employee's designated beneficiary and such spouse dies after the employee, but before distributions have begun to the surviving spouse under section 401(a)(9)(B)(iii) and (iv), how is the employee's interest to be distributed?

A-5. Pursuant to section 401(a)(9)(B)(iv)(II), if the surviving spouse dies after the employee, but before distributions to such spouse have begun under section 401(a)(9)(B)(iii) and (iv), the five-year rule in section 401(a)(9)(B)(ii) and the life expectancy rule in section 401(a)(9)(B)(iii) are to be applied as if the surviving spouse were the employee. In applying this rule, the date of death of the surviving spouse shall be substituted for the date of death of the employee. However, in such case, the rules in section 401(a)(9)(B)(iv) are not available to the surviving spouse of the deceased employee's surviving spouse.

Q-6. For purposes of section 401(a)(9)(B)(iv)(II), when are distributions considered to have begun to the surviving spouse?

A-6. Distributions are considered to have begun to the surviving spouse of an employee, for purposes of section 401(a)(9)(B)(iv)(II), on the date, determined in accordance with A-3 of this section, on which distributions are required to commence to the surviving spouse, even though payments have actually been made before that date. See A-11 of §1.401(a)(9)–6 for a special rule for annuities.

§1.401(a)(9)–4 Determination of the designated beneficiary.

Q-1. Who is a designated beneficiary under section 401(a)(9)(E)?

A-1. A designated beneficiary is an individual who is designated as a beneficiary under the plan. An individual may be designated as a beneficiary under the plan either by the terms of the plan or, if the plan so provides, by an affirmative election by the employee (or the employee's surviving spouse) specifying the beneficiary. A beneficiary designated as such under the plan is an individual who is entitled to a portion of an employee's benefit, contingent on the employee's death or another specified event. For example,

if a distribution is in the form of a joint and survivor annuity over the life of the employee and another individual, the plan does not satisfy section 401(a)(9) unless such other individual is a designated beneficiary under the plan. A designated beneficiary need not be specified by name in the plan or by the employee to the plan in order to be a designated beneficiary so long as the individual who is to be the beneficiary is identifiable under the plan as of the date the beneficiary is determined under A-4 of this section. The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible, as of the date the beneficiary is determined, to identify the class member with the shortest life expectancy. The fact that an employee's interest under the plan passes to a certain individual under applicable state law does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the plan.

Q-2. Must an employee (or the employee's spouse) make an affirmative election specifying a beneficiary for a person to be a designated beneficiary under section 401(a)(9)(E)?

A-2. No. A designated beneficiary is an individual who is designated as a beneficiary under the plan whether or not the designation under the plan was made by the employee. The choice of beneficiary is subject to the requirements of sections 401(a)(11), 414(p), and 417.

Q-3. May a person other than an individual be considered to be a designated beneficiary for purposes of section 401(a)(9)?

A-3. (a) No. Only individuals may be designated beneficiaries for purposes of section 401(a)(9). A person that is not an individual, such as the employee's estate, may not be a designated beneficiary, and, if a person other than an individual is designated as a beneficiary of an employee's benefit, the employee will be treated as having no designated beneficiary for purposes of section 401(a)(9). However, see A-5 of this section for special rules which apply to trusts.

(b) If an employee is treated as having no designated beneficiary, for distributions under a defined contribution plan, the distribution period under section 401(a)(9)(A)(ii) after the death of the employee is limited to the period

described in A-5(a)(2) of §1.401(a)(9)-5 (the remaining life expectancy of the employee determined in accordance with A-5(c)(3) of §1.401(a)(9)-5). Further, in such case, except as provided in A-10 of §1.401(a)(9)-6, if the employee dies before the employee's required beginning date, distribution must be made in accordance with the 5-year rule in section 401(a)(9)(B)(ii).

Q-4. When is the designated beneficiary determined?

A-4. (a) *General rule.* Except as provided in paragraph (b) and §1.401(a)(9)-6, the employee's designated beneficiary will be determined based on the beneficiaries designated as of the last day of the calendar year following the calendar year of the employee's death. Consequently, except as provided in §1.401(a)(9)-6, any person who was a beneficiary as of the date of the employee's death, but is not a beneficiary as of that later date (e.g., because the person disclaims entitlement to the benefit in favor of another beneficiary or because the person receives the entire benefit to which the person is entitled before that date), is not taken into account in determining the employee's designated beneficiary for purposes of determining the distribution period for required minimum distributions after the employee's death.

(b) *Surviving spouse.* As provided in A-5 of §1.401(a)(9)-3, in the case in which the employee's spouse is the designated beneficiary as of the date described in paragraph (a) of this A-5, and the surviving spouse dies after the employee and before the date on which distributions have begun to the spouse under section 401(a)(9)(B)(iii) and (iv), the rule in section 401(a)(9)(B)(iv)(II) will apply. Thus, the relevant designated beneficiary for determining the distribution period is the designated beneficiary of the surviving spouse. Such designated beneficiary will be determined as of the last day of the calendar year following the calendar year of surviving spouse's death. If, as of such last day, there is no designated beneficiary under the plan with respect to that surviving spouse, distribution must be made in accordance with the 5-year rule in section 401(a)(9)(B)(ii) and A-2 of §1.401(a)(9)-3.

(c) *Multiple beneficiaries.* Notwithstanding anything in this A-4 to the contrary, the rules in A-7 of §1.401(a)(9)-5

apply if more than one beneficiary is designated with respect to an employee as of the date on which the designated beneficiary is to be determined in accordance with paragraphs (a) and (b) of this A-4.

Q-5. If a trust is named as a beneficiary of an employee, will the beneficiaries of the trust with respect to the trust's interest in the employee's benefit be treated as having been designated as beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9)?

A-5. (a) Only an individual may be a designated beneficiary for purposes of determining the distribution period under section 401(a)(9). Consequently, a trust is not a designated beneficiary even though the trust is named as a beneficiary. However, if the requirements of paragraph (b) of this A-5 are met, the beneficiaries of the trust will be treated as having been designated as beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9).

(b) The requirements of this paragraph (b) are met if, during any period during which required minimum distributions are being determined by treating the beneficiaries of the trust as designated beneficiaries of the employee, the following requirements are met:

(1) The trust is a valid trust under state law, or would be but for the fact that there is no corpus.

(2) The trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee.

(3) The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable from the trust instrument within the meaning of A-1 of this section.

(4) The documentation described in A-6 of this section has been provided to the plan administrator.

(c) In the case of payments to a trust having more than one beneficiary, see A-7 of §1.401(a)(9)-5 for the rules for determining the designated beneficiary whose life expectancy will be used to determine the distribution period. If the beneficiary of the trust named as beneficiary is another trust, the beneficiaries of the other trust will be treated as having been designated as beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9)

(A)(ii), provided that the requirements of paragraph (b) of this A-5 are satisfied with respect to such other trust in addition to the trust named as beneficiary.

Q-6. If a trust is named as a beneficiary of an employee, what documentation must be provided to the plan administrator?

A-6. (a) *Required minimum distributions before death.* In order to satisfy the documentation requirement of this A-6 for required minimum distributions under section 401(a)(9) to commence before the death of an employee, the employee must comply with either paragraph (a)(1) or (2) of this A-6:

(1) The employee provides to the plan administrator a copy of the trust instrument and agrees that if the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the plan administrator a copy of each such amendment.

(2) The employee—

(i) Provides to the plan administrator a list of all of the beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement);

(ii) Certifies that, to the best of the employee's knowledge, this list is correct and complete and that the requirements of paragraphs (b)(1), (2), and (3) of A-5 of this section are satisfied;

(iii) Agrees that, if the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the plan administrator corrected certifications to the extent that the amendment changes any information previously certified; and

(iv) Agrees to provide a copy of the trust instrument to the plan administrator upon demand.

(b) *Required minimum distributions after death.* In order to satisfy the documentation requirement of this A-6 for required minimum distributions after the death of the employee, by the last day of the calendar year immediately following the calendar year in which the employee died, the trustee of the trust must either - -

(1) Provide the plan administrator with a final list of all beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement) as of the end of the calendar year following the calendar year of the employee's death; certi-

fy that, to the best of the trustee's knowledge, this list is correct and complete and that the requirements of paragraph (b)(1), (2), and (3) of A-5 of this section are satisfied; and agree to provide a copy of the trust instrument to the plan administrator upon demand; or

(2) Provide the plan administrator with a copy of the actual trust document for the trust that is named as a beneficiary of the employee under the plan as of the employee's date of death.

(c) *Relief for discrepancy between trust instrument and employee certifications or earlier trust instruments.* (1) If required minimum distributions are determined based on the information provided to the plan administrator in certifications or trust instruments described in paragraph (a)(1), (a)(2) or (b) of this A-6, a plan will not fail to satisfy section 401(a)(9) merely because the actual terms of the trust instrument are inconsistent with the information in those certifications or trust instruments previously provided to the plan administrator, but only if the plan administrator reasonably relied on the information provided and the required minimum distributions for calendar years after the calendar year in which the discrepancy is discovered are determined based on the actual terms of the trust instrument.

(2) For purposes of determining the amount of the excise tax under section 4974, the required minimum distribution is determined for any year based on the actual terms of the trust in effect during the year.

§1.401(a)(9)-5 Required minimum distributions from defined contribution plans.

Q-1. If an employee's benefit is in the form of an individual account under a defined contribution plan, what is the amount required to be distributed for each calendar year?

A-1. (a) *General rule.* If an employee's accrued benefit is in the form of an individual account under a defined contribution plan, the minimum amount required to be distributed for each distribution calendar year, as defined in paragraph (b) of this A-1, is equal to the quotient obtained by dividing the account (determined under A-3 of this section) by the applicable distribution period (deter-

mined under A-4 of this section). However, the required minimum distribution amount will never exceed the entire vested account balance on the date of the distribution. Further, the minimum distribution required to be distributed on or before an employee's required beginning date is always determined under section 401(a)(9)(A)(ii) and this A-1 and not section 401(a)(9)(A)(i).

(b) *Distribution calendar year.* A calendar year for which a minimum distribution is required is a distribution calendar year. If an employee's required beginning date is April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2, the employee's first distribution calendar year is the year the employee attains age 70 1/2. If an employee's required beginning date is April 1 of the calendar year following the calendar year in which the employee retires, the calendar year in which the employee retires is the employee's first distribution calendar year. In the case of distributions to be made in accordance with the life expectancy rule in §1.401(a)(9)-3 and in section 401(a)(9)(B)(iii) and (iv), the first distribution calendar year is the calendar year containing the date described in A-3(a) or A-3(b) of §1.401(a)(9)-3, whichever is applicable.

(c) *Time for distributions.* The distribution required to be made on or before the employee's required beginning date shall be treated as the distribution required for the employee's first distribution calendar year (as defined in paragraph (b) of this A-1). The required minimum distribution for other distribution calendar years, including the required minimum distribution for the distribution calendar year in which the employee's required beginning date occurs, must be made on or before the end of that distribution calendar year.

(d) *Minimum distribution incidental benefit requirement.* If distributions are made in accordance with this section, the minimum distribution incidental benefit requirement of section 401(a)(9)(G) will be satisfied.

(e) *Annuity contracts.* Instead of satisfying this A-1, the required minimum distribution requirement may be satisfied by the purchase of an annuity contract from an insurance company in accordance with A-4 of §1.401(a)(9)-6 with the employ-

ee's entire individual account. If such an annuity is purchased after distributions are required to commence (the required beginning date, in the case of distributions commencing before death, or the date determined under A-3 of §1.401(a)(9)-3, in the case of distributions commencing after death), payments under the annuity contract purchased will satisfy section 401(a)(9) for distribution calendar years after the calendar year of the purchase if payments under the annuity contract are made in accordance with §1.401(a)(9)-6. In such a case, payments under the annuity contract will be treated as distributions from the individual account for purposes of determining if the individual account satisfies section 401(a)(9) for the calendar year of the purchase. An employee may also purchase an annuity contract for a portion of the employee's account under the rules of A-2(c) of §1.401(a)(9)-8.

Q-2. If an employee's benefit is in the form of an individual account and, in any calendar year, the amount distributed exceeds the minimum required, will credit be given in subsequent calendar years for such excess distribution?

A-2. If, for any distribution calendar year, the amount distributed exceeds the minimum required, no credit will be given in subsequent calendar years for such excess distribution.

Q-3. What is the amount of the account of an employee used for determining the employee's required minimum distribution in the case of an individual account?

A-3. (a) In the case of an individual account, the benefit used in determining the required minimum distribution for a distribution calendar year is the account balance as of the last valuation date in the calendar year immediately preceding that distribution calendar year (valuation calendar year) adjusted in accordance with paragraphs (b) and (c) of this A-3.

(b) The account balance is increased by the amount of any contributions or forfeitures allocated to the account balance as of dates in the valuation calendar year after the valuation date. Contributions include contributions made after the close of the valuation calendar year which are allocated as of dates in the valuation calendar year.

(c)(1) The account balance is decreased by distributions made in the valuation calendar year after the valuation date.

(2)(i) The following rule applies if any portion of the required minimum distribution for the first distribution calendar year is made in the second distribution calendar year (i.e., generally, the distribution calendar year in which the required beginning date occurs). In such case, for purposes of determining the account balance to be used for determining the required minimum distribution for the second distribution calendar year, distributions described in paragraph (c)(1) shall include an additional amount. This additional amount is equal to the amount of any distribution made in the second distribution calendar year on or before the required beginning date that is not in excess (when added to the amounts distributed in the first calendar year) of the amount required to meet the required minimum distribution for the first distribution calendar year.

(ii) This paragraph (c)(2) is illustrated by the following example:

Example. (i) Employee X, born October 1, 1931, is an unmarried participant in a qualified defined contribution plan (Plan Z). After retirement, X attains age 70 1/2 in calendar year 2002. X's required beginning date is April 1, 2003. As of the last valuation date under Plan Z in calendar year 2001, which was on December 31, 2001, the value of X's account balance was \$25,300. No contributions are made or amounts forfeited after such date which are allocated in calendar year 2001. No rollover amounts are received after such date by Plan Z on X's behalf which were distributed by a qualified plan or IRA in calendar years 2001, 2002, or 2003. The applicable distribution period from the table in A-4(a)(2) for an individual age 71 is 25.3 years. The required minimum distribution for calendar year 2002 is \$1,000 (\$25,300 divided by 25.3). That amount is distributed to X on April 1, 2003.

(ii) The value of X's account balance as of December 31, 2002 (the last valuation date under Plan Z in calendar year 2002) is \$26,400. No contributions are made or amounts forfeited after such date which are allocated in calendar year 2002. In order to determine the benefit to be used in calculating the required minimum distribution for calendar year 2003, the account balance of \$26,400 will be reduced by \$1,000, the amount of the required minimum distribution for calendar year 2002 made on April 1, 2003. Consequently, the benefit for purposes of determining the required minimum distribution for calendar year 2003 is \$25,400.

(iii) If, instead of \$1,000 being distributed to X, \$20,000 is distributed on April 1, 2003, the account balance of \$26,400 would still be reduced by \$1,000 in order to determine the benefit to be used in calculating the required minimum distribution for calendar year 2003. The amount of the distribution made on April 1, 2003, in order to meet the required minimum distribution for 2002 would still be \$1,000. The remaining \$19,000 (\$20,000 - \$1,000) of the distribution is not the required minimum distribution for 2002. Instead, the remaining \$19,000 of the distribution is sufficient to satisfy the required minimum distribution requirement with respect to X for calendar year 2003. The amount which is required to be distributed for calendar year 2003 is \$1,040.10 (\$25,400 divided by 24.4, the applicable distribution period for an individual age 72). Consequently, no additional amount is required to be distributed to X in 2003 because \$19,000 exceeds \$1,040.10. However, pursuant to A-2 of this section, the remaining \$17,959.90 (\$19,000-\$1,040.10) may not be used to satisfy the required minimum distribution requirements for calendar year 2004 or any subsequent calendar years.

(d) If an amount is distributed by one plan and rolled over to another plan (receiving plan), A-2 of §1.401(a)(9)-7 provides additional rules for determining the benefit and required minimum distribution under the receiving plan. If an amount is transferred from one plan (transferor plan) to another plan (transferee plan), A-3 and A-4 of §1.401(a)(9)-7 provide additional rules for determining the amount of the required minimum distribution and the benefit under both the transferor and transferee plans.

Q-4. For required minimum distributions during an employee's lifetime, what is the applicable distribution period?

A-4. (a) *General rule*— (1) *Applicable distribution period.* Except as provided in paragraph (b) of this A-4, the applicable distribution period for required minimum distributions for distribution calendar years up to and including the distribution calendar year that includes the employee's date of death is determined using the table in paragraph (a)(2) for the employee's age as of the employee's birthday in the relevant distribution calendar year.

(2) *Table for determining distribution period*—(i) *General rule.* The following table is used for determining the distribution period for lifetime distributions to an employee.

<i>Age of the employee</i>	<i>Distribution period</i>
70	26.2
71	25.3
72	24.4
73	23.5
74	22.7
75	21.8
76	20.9
77	20.1
78	19.2
79	18.4
80	17.6
81	16.8
82	16.0
83	15.3
84	14.5
85	13.8
86	13.1
87	12.4
88	11.8
89	11.1
90	10.5
91	9.9
92	9.4
93	8.8
94	8.3
95	7.8
96	7.3
97	6.9
98	6.5
99	6.1
100	5.7
101	5.3
102	5.0
103	4.7
104	4.4
105	4.1
106	3.8
107	3.6
108	3.3
109	3.1
110	2.8
111	2.6
112	2.4
113	2.2
114	2.0
115 and older	1.8

(ii) *Authority for revised table.* The table in A-4(a)(2)(i) of this section may be replaced by any revised table prescribed by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin. See §601.601 (d)(2)(ii)(b) of this chapter.

(b) *Spouse is sole beneficiary.* If the sole designated beneficiary of an employ-

ee is the employee's surviving spouse, for required minimum distributions during the employee's lifetime, the applicable distribution period is the longer of the distribution period determined in accordance with paragraph (a) of this A-4 or the joint life expectancy of the employee and spouse using the employee's and spouse's attained ages as of the employee's and the

spouse's birthdays in the distribution calendar year. The spouse is sole designated beneficiary for purposes of determining the applicable distribution period for a distribution calendar year during the employee's lifetime if the spouse is the sole beneficiary of the employee's entire interest at all times during the distribution calendar year.

Q-5. For required minimum distributions after an employee's death, what is the applicable distribution period?

A-5. (a) *Death on or after the employee's required beginning date.* If an employee dies on or after distribution has begun as determined under A-6 of §1.401(a)(9)-2 (generally after the employee's required beginning date), in order to satisfy section 401(a)(9)(B)(i), the applicable distribution period for distribution calendar years after the distribution calendar year containing the employee's date of death is either—

(1) If the employee has a designated beneficiary as of the date determined under A-4 of §1.401(a)(9)-4, the remaining life expectancy of the employee's designated beneficiary determined in accordance with paragraph(c)(1) or (2) of A-5; or

(2) If the employee does not have a designated beneficiary as of the date determined under A-4(a) of §1.401(a)(9)-4, the remaining life expectancy of the employee determined in accordance with paragraph (c)(3) of this A-5.

(b) *Death before an employee's required beginning date.* If an employee dies before distribution has begun as determined under A-5 of §1.401(a)(9)-2 (generally before the employee's required beginning date), in order to satisfy section 401(a)(9)(B)(iii) or (iv) and the life expectancy rule described in A-1 of §1.401(a)(9)-3, the applicable distribution period for distribution calendar years after the distribution calendar year containing the employee's date of death is the remaining life expectancy of the employee's designated beneficiary, determined in accordance with paragraph (c)(1) or (2) of this A-5.

(c) *Life expectancy*—(1) *Nonspouse designated beneficiary.* The applicable distribution period measured by the beneficiary's remaining life expectancy is determined using the beneficiary's age as of the beneficiary's birthday in the calendar year immediately following the calendar year of the employee's death. In subsequent calendar years the applicable distribution period is reduced by one for each calendar year that has elapsed since the calendar year immediately following the calendar year of the employee's death.

(2) *Spouse designated beneficiary.* If the surviving spouse of the employee is

the employee's sole beneficiary, the applicable period is measured by the surviving spouse's life expectancy using the surviving spouse's birthday for each distribution calendar year for which a required minimum distribution is required after the calendar year of the employee's death. For calendar years after the calendar year of the spouse's death, the spouse's remaining life expectancy is the life expectancy of the spouse using the age of the spouse as of the spouse's birthday in the calendar year of the spouse's death. In subsequent calendar years, the applicable distribution period is reduced by one for each calendar year that has elapsed since the calendar year immediately following the calendar year of the spouse's death.

(3) *No designated beneficiary.* The applicable distribution period measured by the employee's remaining life expectancy is the life expectancy of the employee using the age of the employee as of the employee's birthday in the calendar year of the employee's death. In subsequent calendar years the applicable distribution period is reduced by one for each calendar year that has elapsed since the calendar year of death.

Q-6. What life expectancies must be used for purposes of determining required minimum distributions under section 401(a)(9)?

A-6. (a) *General rule.* Unless otherwise prescribed in accordance with paragraph (b) of this A-6, life expectancies for purposes of determining required minimum distributions under section 401(a)(9) must be computed using the expected return multiples in Tables V and VI of §1.72-9.

(b) *Revised expected return table.* The expected return multiples described in paragraph (a) of this A-6 may be replaced by revised expected return multiples prescribed for use for purposes of determining required minimum distributions under section 401(a)(9) by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b) of this chapter.

Q-7. If an employee has more than one designated beneficiary, which designated beneficiary's life expectancy will be used to determine the applicable distribution period?

A-7. (a) *General rule.* (1) Except as otherwise provided in paragraph (c) of this A-7, if more than one individual is designated as a beneficiary with respect to an employee as of any applicable date for determining the designated beneficiary, the designated beneficiary with the shortest life expectancy will be the designated beneficiary for purposes of determining the distribution period. However, except as otherwise provided in A-5 of §1.401(a)(9)-4 and paragraph (c)(1) of this A-7, if a person other than an individual is designated as a beneficiary, the employee will be treated as not having any designated beneficiaries for purposes of section 401(a)(9) even if there are also individuals designated as beneficiaries.

(2) See A-2 of §1.401(a)(9)-8 for special rules which apply if an employee's benefit under a plan is divided into separate accounts (or segregated shares in the case of a defined benefit plan) and the beneficiaries with respect to a separate account differ from the beneficiaries of another separate account.

(b) *Contingent beneficiary.* Except as provided in paragraph (c)(1) of this A-7, if a beneficiary's entitlement to an employee's benefit is contingent on an event other than the employee's death or the death of another beneficiary, such contingent beneficiary is considered to be a designated beneficiary for purposes of determining which designated beneficiary has the shortest life expectancy under paragraph (a) of this A-7.

(c) *Death contingency.* (1) If a beneficiary (subsequent beneficiary) is entitled to any portion of an employee's benefit only if another beneficiary dies before the entire benefit to which that other beneficiary is entitled has been distributed by the plan, the subsequent beneficiary will not be considered a beneficiary for purposes of determining who is the designated beneficiary with the shortest life expectancy under paragraph (a) of this A-7 or whether a beneficiary who is not an individual is a beneficiary. This rule does not apply if the other beneficiary dies prior to the applicable date for determining the designated beneficiary.

(2) If the designated beneficiary whose life expectancy is being used to calculate the distribution period dies on or after the applicable date, such beneficiary's remaining life expectancy will be used to

determine the distribution period whether or not a beneficiary with a shorter life expectancy receives the benefits.

(3) This paragraph (c) is illustrated by the following examples:

Example 1. Employer L maintains a defined contribution plan, Plan W. Unmarried Employee C dies in calendar year 2001 at age 30. As of December 31, 2002, D, the sister of C, is the beneficiary of C's account balance under Plan W. Prior to death C has designated that, if D dies before C's entire account balance has been distributed to D, E, mother of C and D, will be the beneficiary of the account balance. Because E is only entitled, as a beneficiary, to any portion of C's account if D dies before the entire account has been distributed, E is disregarded in determining C's designated beneficiary. Accordingly, even after D's death, D's life expectancy continues to be used to determine the distribution period.

Example 2. (i) Employer M maintains a defined contribution plan, Plan X. Employee A, an employee of M, died in 2001 at the age of 55, survived by spouse, B, who was 50 years old. Prior to A's death, M had established an account balance for A in Plan X. A's account balance is invested only in productive assets. A named the trustee of a testamentary trust (Trust P) established under A's will as the beneficiary of all amounts payable from the A's account in Plan X after A's death. A copy of the Trust P and a list of the trust beneficiaries were provided to the plan administrator of Plan X by the end of the calendar year following the calendar year of A's death. As of the date of A's death, the Trust P was irrevocable and was a valid trust under the laws of the state of A's domicile. A's account balance in Plan X was includible in A's gross estate under § 2039.

(ii) Under the terms of Trust P, all trust income is payable annually to B, and no one has the power to appoint Trust P principal to any person other than B. A's children, who are all younger than B, are the sole remainder beneficiaries of the Trust P. No other person has a beneficial interest in Trust P. Under the terms of the Trust P, B has the power, exercisable annually, to compel the trustee to withdraw from A's account balance in Plan X an amount equal to the income earned on the assets held in A's account in Plan X during the calendar year and to distribute that amount through Trust P to B. Plan X contains no prohibition on withdrawal from A's account of amounts in excess of the annual required minimum distributions under section 401(a)(9). In accordance with the terms of Plan X, the trustee of Trust P elects, in order to satisfy section 401(a)(9), to receive annual required minimum distributions using the life expectancy rule in section 401(a)(9)(B)(iii) for distributions over a distribution period equal to B's life expectancy. If B exercises the withdrawal power, the trustee must withdraw from A's account under Plan X the greater of the amount of income earned in the account during the calendar year or the required minimum distribution. However, under the terms of Trust P, and applicable state law, only the portion of the Plan X distribution received by the trustee equal to the income earned by A's account in Plan X is required to be distributed to B (along with any other trust income.)

(iii) Because some amounts distributed from A's account in Plan X to Trust P may be accumulated in

Trust P during B's lifetime for the benefit of A's children, as remaindermen beneficiaries of Trust P, even though access to those amounts are delayed until after B's death, A's children are beneficiaries of A's account in Plan X in addition to B and B is not the sole beneficiary of A's account. Thus the designated beneficiary used to determine the distribution period from A's account in Plan X is the beneficiary with the shortest life expectancy. B's life expectancy is the shortest of all the potential beneficiaries of the testamentary trust's interest in A's account in Plan X (including remainder beneficiaries). Thus, the distribution period for purposes of section 401(a)(9)(B)(iii) is B's life expectancy. Because B is not the sole beneficiary of the testamentary trust's interest in A's account in Plan X, the special rule in 401(a)(9)(B)(iv) is not available and the annual required minimum distributions from the account to Trust M must begin no later than the end of the calendar year immediately following the calendar year of A's death.

Example 3. (i) The facts are the same as *Example 2* except that the testamentary trust instrument provides that all amounts distributed from A's account in Plan X to the trustee while B is alive will be paid directly to B upon receipt by the trustee of Trust P.

(ii) In this case, B is the sole beneficiary of A's account in Plan X for purposes of determining the designated beneficiary under section 401(a)(9)(B)(iii) and (iv). No amounts distributed from A's account in Plan X to Trust P are accumulated in Trust P during B's lifetime for the benefit of any other beneficiary. Because B is the sole beneficiary of the testamentary trust's interest in A's account in Plan X, the annual required minimum distributions from A's account to Trust P must begin no later than the end of the calendar year in which A would have attained age 70 1/2 rather than the calendar year immediately following the calendar year of A's death.

(d) *Designations by beneficiaries.* (1) If the plan provides (or allows the employee to specify) that, after the end of the calendar year following the calendar year in which the employee died, any person or persons have the discretion to change the beneficiaries of the employee, then, for purposes of determining the distribution period after the employee's death, the employee will be treated as not having designated a beneficiary. However, such discretion will not be found to exist merely because a beneficiary may designate a subsequent beneficiary for distributions of any portion of the employee's benefit after the beneficiary dies.

(2) This paragraph (d) is illustrated by the following example:

Example. The facts are the same as in *Example 1* in paragraph (c)(3) of this A-7, except that, as permitted under the plan, D designates E as the beneficiary of any amount remaining after the death of D rather than C making this designation. E is still disregarded in determining C's designated beneficiary for purposes of section 401(a)(9).

Q-8. If a portion of an employee's individual account is not vested as of the employee's required beginning date, how is the determination of the required minimum distribution affected?

A-8. If the employee's benefit is in the form of an individual account, the benefit used to determine the required minimum distribution for any distribution calendar year will be determined in accordance with A-1 of this section without regard to whether or not all of the employee's benefit is vested. If any portion of the employee's benefit is not vested, distributions will be treated as being paid from the vested portion of the benefit first. If, as of the end of a distribution calendar year (or as of the employee's required beginning date, in the case of the employee's first distribution calendar year), the total amount of the employee's vested benefit is less than the required minimum distribution for the calendar year, only the vested portion, if any, of the employee's benefit is required to be distributed by the end of the calendar year (or, if applicable, by the employee's required beginning date). However, the required minimum distribution for the subsequent distribution calendar year must be increased by the sum of amounts not distributed in prior calendar years because the employee's vested benefit was less than the required minimum distribution (subject to the limitation that the required minimum distribution for that subsequent distribution calendar year will not exceed the vested portion of the employee's benefit). In such case, an adjustment for the additional amount distributed which corresponds to the adjustment described in A-3(c)(2) of this section will be made to the account used to determine the required minimum distribution for that calendar year.

§1.401(a)(9)-6 Required minimum distributions from defined benefit plans.

Q-1. How must annuity distributions under a defined benefit plan be paid in order to satisfy section 401(a)(9)?

A-1. (a) In order to satisfy section 401(a)(9), annuity distributions under a defined benefit plan must be paid in periodic payments made at intervals not longer than one year (payment intervals) for a life (or lives), or over a period certain not longer than a life expectancy (or

joint life and last survivor expectancy) described in section 401(a)(9)(A)(ii) or section 401(a)(9)(B)(iii), whichever is applicable. The life expectancy (or joint life and last survivor expectancy) for purposes of determining the length of the period certain will be determined in accordance with A-3 of this section. Once payments have commenced over a period certain, the period certain may not be lengthened even if the period certain is shorter than the maximum permitted. Life annuity payments must satisfy the minimum distribution incidental benefit requirements of A-2 of this section. All annuity payments (life and period certain) also must either be nonincreasing or increase only as follows:

(1) With any percentage increase in a specified and generally recognized cost-of-living index;

(2) To the extent of the reduction in the amount of the employee's payments to provide for a survivor benefit upon death, but only if the beneficiary whose life was being used to determine the period described in section 401(a)(9)(A)(ii) over which payments were being made dies or is no longer the employee's beneficiary pursuant to a qualified domestic relations order within the meaning of section 414(p);

(3) To provide cash refunds of employee contributions upon the employee's death; or

(4) Because of an increase in benefits under the plan.

(b) The annuity may be a life annuity (or joint and survivor annuity) with a period certain if the life (or lives, if applicable) and period certain each meet the requirements of paragraph (a) of this A-1. For purposes of this section, if distribution is permitted to be made over the lives of the employee and the designated beneficiary, references to life annuity include a joint and survivor annuity.

(c) Distributions under a variable annuity will not be found to be increasing merely because the amount of the payments varies with the investment performance of the underlying assets. However, the Commissioner may prescribe additional requirements applicable to such variable life annuities in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b) of this chapter.

(d) (1) Except as provided in (d)(2) of this A-1, annuity payments must commence on or before the employee's required beginning date (within the meaning of A-2 of §1.401(a)(9)-2). The first payment which must be made on or before the employee's required beginning date must be the payment which is required for one payment interval. The second payment need not be made until the end of the next payment interval even if that payment interval ends in the next calendar year. Similarly, in the case of distributions commencing after death in accordance with section 401(a)(9)(B)(iii) and (iv), the first payment that must be made on or before the date determined under A-3(a) or (b) (whichever is applicable) of §1.401(a)(9)-3 must be the payment which is required for one payment interval. Payment intervals are the periods for which payments are received, e.g., bimonthly, monthly, semi-annually, or annually. All benefit accruals as of the last day of the first distribution calendar year must be included in the calculation of the amount of the life annuity payments for payment intervals ending on or after the employee's required beginning date.

(2) In the case of an annuity contract purchased after the required beginning date, the first payment interval must begin on or before the purchase date and the payment required for one payment interval must be made no later than the end of such payment interval.

(3) This paragraph (d) is illustrated by the following example:

Example. A defined benefit plan (Plan X) provides monthly annuity payments of \$500 for the life of unmarried participants with a 10-year period certain. An unmarried participant (A) in Plan X attains age 70 $\frac{1}{2}$ in 2001. In order to meet the requirements of this paragraph, the first payment which must be made on behalf of A on or before April 1, 2002, will be \$500 and the payments must continue to be made in monthly payments of \$500 thereafter for the life and 10-year certain period.

(e) If distributions from a defined benefit plan are not in the form of an annuity, the employee's benefit will be treated as an individual account for purposes of determining the required minimum distribution. See §1.401(a)(9)-5.

Q-2. How must distributions in the form of a life (or joint and survivor) annuity be made in order to satisfy the minimum distribution incidental benefit (MDIB) requirement of section 401(a)(9)(G)?

A-2. (a) *Life annuity for employee.* If the employee's benefit is payable in the form of a life annuity for the life of the employee satisfying section 401(a)(9), the MDIB requirement of section 401(a)(9)(G) will be satisfied.

(b) *Joint and survivor annuity, spouse beneficiary.* If the employee's sole beneficiary, as of the annuity starting date for annuity payments, is the employee's spouse and the distributions satisfy section 401(a)(9) without regard to the MDIB requirement, the distributions to the employee will be deemed to satisfy the MDIB requirement of section 401(a)(9)(G). For example, if an employee's benefit is being distributed in the form of a joint and survivor annuity for the lives of the employee and the employee's spouse and the spouse is the sole beneficiary of the employee, the amount of the periodic payment payable to the spouse may always be 100 percent of the annuity payment payable to the employee regardless of the difference in the ages between the employee and the employee's spouse. However, the amount of the payments under the annuity must be nonincreasing unless specifically permitted under A-1 of this section.

(c) *Joint and survivor annuity, non-spouse beneficiary — (1) Explanation of rule.* If distributions commence under a distribution option that is in the form of a joint and survivor annuity for the joint lives of the employee and a beneficiary other than the employee's spouse, the MDIB requirement will not be satisfied as of the date distributions commence unless the distribution option provides that annuity payments to be made to the employee on and after the employee's required beginning date will satisfy the conditions of this paragraph. The periodic annuity payment payable to the survivor must not at any time on and after the employee's required beginning date exceed the applicable percentage of the annuity payment payable to the employee using the table below. Thus, this requirement must be satisfied with respect to any benefit increase after such date, including increases to reflect increases in the cost of living. The applicable percentage is based on the excess of the age of the employee over the age of the beneficiary as of their attained ages as of their birthdays in a calendar year. If the

employee has more than one beneficiary, the applicable percentage will be the percentage using the age of the youngest beneficiary. Additionally, the amount of the annuity payments must satisfy A-1 of this section.

(2) *Table.*

Excess of age of employee over age of beneficiary	Applicable percentage
10 years or less	100%
11	96%
12	93%
13	90%
14	87%
15	84%
16	82%
17	79%
18	77%
19	75%
20	73%
21	72%
22	70%
23	68%
24	67%
25	66%
26	64%
27	63%
28	62%
29	61%
30	60%
31	59%
32	59%
33	58%
34	57%
35	56%
36	56%
37	55%
38	55%
39	54%
40	54%
41	53%
42	53%
43	53%
44 and greater	52%

(3) *Example.* This paragraph (c) is illustrated by the following example:

Example. Distributions commence on January 1, 2001, to an employee (Z), born March 1, 1935, after retirement at age 65. Z's daughter (Y), born February 5, 1965, is Z's beneficiary. The distributions are in the form of a joint and survivor annuity for the lives of Z and Y with payments of \$500 a month to Z and upon Z's death of \$500 a month to Y, i.e., the projected

monthly payment to Y is 100 percent of the monthly amount payable to Z. There is no provision under the option for a change in the projected payments to Y as of April 1, 2006, Z's required beginning date. Consequently, as of January 1, 2001, the date annuity distributions commence, the plan does not satisfy the MDIB requirement in operation because, as of such date, the distribution option provides that, as of Z's required beginning date, the monthly payment to Y

upon Z's death will exceed 60 percent of Z's monthly payment (the maximum percentage for a difference of ages of 30 years).

(d) *Period certain and annuity features.* If a distribution form includes a life annuity and a period certain, the amount of the annuity payments payable to the employee must satisfy paragraph (c) of

this A-2, and the period certain may not exceed the period determined under A-3 of this section.

Q-3. How long is a period certain under an annuity contract permitted to extend?

A-3. (a) *Distributions commencing during the employee's life* - - (1) *Spouse beneficiary*. If an employee's spouse is the employee's sole beneficiary as of the annuity starting date, the period certain for annuity distributions commencing during the life of an employee with an annuity starting date on or after the employee's required beginning date is not permitted to exceed the joint life and last survivor expectancy of the employee and the spouse using the age of the employee and spouse as of their birthdays in the calendar year that contains the annuity starting date.

(2) *Nonspouse beneficiary*. If an employee's surviving spouse is not the employee's sole beneficiary as of the annuity starting date, the period certain for any annuity distributions during the life of the employee with an annuity starting date on or after the employee's required beginning date is not permitted to exceed the shorter of the applicable distribution period for the employee (determined in accordance with the table in A-4(a)(2) of §1.401(a)(9)-5) for the calendar year that contains the annuity starting date or the joint life and last survivor expectancy of the employee and the employee's designated beneficiary, determined using the designated beneficiary as of the annuity starting date and using their ages as of their birthdays in the calendar year that contains the annuity starting date. See A-10 for the rule for annuity payments with an annuity starting date before the required beginning date.

(b) *Life expectancy rule*. (1) If annuity distributions commence after the death of the employee under the life expectancy rule (under section 401(a)(9)(iii) or (iv)), the period certain for any distributions commencing after death cannot exceed the applicable distribution period determined under A-5(b) of §1.401(a)(9)-5 for the distribution calendar year that contains the annuity starting date.

(2) If the annuity starting date is in a calendar year before the first distribution calendar year, the period certain may not

exceed the life expectancy of the designated beneficiary using the beneficiary's age in the year that contains the annuity starting date.

Q-4. May distributions be made from an annuity contract which is purchased from an insurance company?

A-4. Yes. Distributions may be made from an annuity contract which is purchased with the employee's benefit by the plan from an insurance company and which makes payments that satisfy the provisions of this section. In the case of an annuity contract purchased from an insurance company, there is also an exception to the nonincreasing requirement in A-1(a) of this section for an increase to provide a cash refund upon the employee's death equal to the excess of the amount of the premiums paid for the contract over the prior distributions under the contract. If the payments actually made under the annuity contract do not meet the requirements of section 401(a)(9), the plan fails to satisfy section 401(a)(9).

Q-5. In the case of annuity distributions under a defined benefit plan, how must additional benefits which accrue after the employee's required beginning date be distributed in order to satisfy section 401(a)(9)?

A-5. (a) In the case of annuity distributions under a defined benefit plan, if any additional benefits accrue after the employee's required beginning date, distribution of such amount as a separate identifiable component must commence in accordance with A-1 of this section beginning with the first payment interval ending in the calendar year immediately following the calendar year in which such amount accrues.

(b) A plan will not fail to satisfy section 401(a)(9) merely because there is an administrative delay in the commencement of the distribution of the separate identifiable component, provided that the actual payment of such amount commences as soon as practicable but not later than by the end of the first calendar year following the calendar year in which the additional benefit accrues, and that the total amount paid during such first calendar year is not less than the total amount that was required to be paid during that year under A-5(a) of this section.

Q-6. If a portion of an employee's benefit is not vested as of the employee's required beginning date, how is the determination of the required minimum distribution affected?

A-6. In the case of annuity distributions from a defined benefit plan, if any portion of the employee's benefit is not vested as of December 31 of a distribution calendar year (or as of the employee's required beginning date in the case of the employee's first distribution calendar year), the portion which is not vested as of such date will be treated as not having accrued for purposes of determining the required minimum distribution for that distribution calendar year. When an additional portion of the employee's benefit becomes vested, such portion will be treated as an additional accrual. See A-5 of this section for the rules for distributing benefits which accrue under a defined benefit plan after the employee's required beginning date.

Q-7. If an employee retires after the calendar year in which the employee attains age 70 1/2, for what period must the employee's accrued benefit under a defined benefit plan be actuarially increased?

A-7. (a) *Actuarial increase starting date*. If an employee (other than a 5-percent owner) retires after the calendar year in which the employee attains age 70 1/2, in order to satisfy section 401(a)(9)(C)(iii), the employee's accrued benefit under a defined benefit plan must be actuarially increased to take into account any period after age 70 1/2 in which the employee was not receiving any benefits under the plan. The actuarial increase required to satisfy section 401(a)(9)(C)(iii) must be provided for the period starting on the April 1 following the calendar year in which the employee attains age 70 1/2.

(b) *Actuarial increase ending date*. The period for which the actuarial increase must be provided ends on the date on which benefits commence after retirement in an amount sufficient to satisfy section 401(a)(9).

(c) *Nonapplication to plan providing same required beginning date for all employees*. If as permitted under A-2(e) of §1.401(a)(9)-2, a plan provides that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which the employee

attained age 70 1/2 (regardless of whether the employee is a 5-percent owner) and the plan makes distributions in an amount sufficient to satisfy section 401(a)(9) using that required beginning date, no actuarial increase is required under section 401(a)(9)(C)(iii).

(d) *Nonapplication to defined contribution plans.* The actuarial increase required under this A-7 does not apply to defined contribution plans.

(e) *Nonapplication to governmental and church plans.* The actuarial increase required under this A-7 does not apply to a governmental plan (within the meaning of section 414(d)) or a church plan. For purposes of this paragraph, the term *church plan* means a plan maintained by a church for church employees, and the term *church* means any church (as defined in section 3121(w)(3)(A)) or qualified church-controlled organization (as defined in section 3121(w)(3)(B)).

Q-8. What amount of actuarial increase is required under section 401(a)(9)(C)(iii)?

A-8. In order to satisfy section 401(a)(9)(C)(iii), the retirement benefits payable with respect to an employee as of the end of the period for actuarial increases (described in A-7 of this section) must be no less than: the actuarial equivalent of the employee's retirement benefits that would have been payable as of the date the actuarial increase must commence under A-7(a) of this section if benefits had commenced on that date; plus the actuarial equivalent of any additional benefits accrued after that date; reduced by the actuarial equivalent of any distributions made with respect to the employee's retirement benefits after that date. Actuarial equivalence is determined using the plan's assumptions for determining actuarial equivalence for purposes of satisfying section 411.

Q-9. How does the actuarial increase required under section 401(a)(9)(C)(iii) relate to the actuarial increase required under section 411?

A-9. In order for any of an employee's accrued benefit to be nonforfeitable as required under section 411, a defined benefit plan must make an actuarial adjustment to an accrued benefit the payment of which is deferred past normal retirement age. The only exception to this rule is that

generally no actuarial adjustment is required to reflect the period during which a benefit is suspended as permitted under section 203(a)(3)(B) of the Employee Retirement Income Security Act of 1974 (ERISA). The actuarial increase required under section 401(a)(9) for the period described in A-7 of this section is generally the same as, and not in addition to, the actuarial increase required for the same period under section 411 to reflect any delay in the payment of retirement benefits after normal retirement age. However, unlike the actuarial increase required under section 411, the actuarial increase required under section 401(a)(9)(C) must be provided even during the period during which an employee's benefit has been suspended in accordance with ERISA section 203(a)(3)(B).

Q-10. What rule applies if distributions commence to an employee on a date before the employee's required beginning date over a period permitted under section 401(a)(9)(A)(ii) and the distribution form is an annuity under which distributions are made in accordance with the provisions of A-1 (and if applicable A-4) of this section?

A-10. (a) *General rule.* If distributions irrevocably (except for acceleration) commence to an employee on a date before the employee's required beginning date over a period permitted under section 401(a)(9)(A)(ii) and the distribution form is an annuity under which distributions are made in accordance with the provisions of A-1 (and, if applicable, A-4) of this section, the annuity starting date will be treated as the required beginning date for purposes of applying the rules of this section and §1.401(a)(9)-3. Thus, for example, the designated beneficiary distributions will be determined as of the annuity starting date. Similarly, if the employee dies after the annuity starting date but before the required beginning date determined under A-2 of §1.401(a)(9)-2, after the employee's death, the remaining portion of the employee's interest must continue to be distributed in accordance with this section over the remaining period over which distributions commenced (single or joint lives and, if applicable, period certain). The rules in §1.401(a)(9)-3 and section 401(a)(9)(B)(ii) or (iii) and (iv) do not apply.

(b) *Period certain.* If as of the employee's birthday in the year that contains the annuity starting date, the age of the employee is under 70, the following rule applies in applying the rule in paragraph (a)(2) of A-3 of this section. The applicable distribution period for the employee (determined in accordance with the table in A-4(a)(2) of §1.401(a)(9)-5) is 26.2 plus the difference between 70 and the age of the employee as of the employee's birthday in the year that contains the annuity starting date.

Q-11. What rule applies if distributions commence irrevocably (except for acceleration) to the surviving spouse of an employee over a period permitted under section 401(a)(9)(B)(iii)(II) before the date on which distributions are required to commence and the distribution form is an annuity under which distributions are made as of the date distributions commence in accordance with the provisions of A-1 (and if applicable A-4) of this section?

A-11. If distributions commence irrevocably (except for acceleration) to the surviving spouse of an employee over a period permitted under section 401(a)(9)(B)(iii)(II) before the date on which distributions are required to commence and the distribution form is an annuity under which distributions are made as of the date distributions commence in accordance with the provisions of A-1 (and if applicable A-4) of this section, distributions will be considered to have begun on the actual commencement date for purposes of section 401(a)(9)(B)(iv)(II). Consequently, in such case, A-5 of §1.401(a)(9)-3 and section 401(a)(9)(B)(ii) and (iii) will not apply upon the death of the surviving spouse as though the surviving spouse were the employee. Instead, the annuity distributions must continue to be made, in accordance with the provisions of A-1 (and if applicable A-4) of this section over the remaining period over which distributions commenced (single life and, if applicable, period certain).

§1.401(a)(9)-7 Rollovers and Transfers.

Q-1. If an amount is distributed by one plan (distributing plan) and is rolled over to another plan, is the benefit or the required minimum distribution under the distributing plan affected by the rollover?

A-1. No. If an amount is distributed by one plan and is rolled over to another plan, the amount distributed is still treated as a distribution by the distributing plan for purposes of section 401(a)(9), notwithstanding the rollover.

Q-2. If an amount is distributed by one plan (distributing plan) and is rolled over to another plan (receiving plan), how are the benefit and the required minimum distribution under the receiving plan affected?

A-2. If an amount is distributed by one plan (distributing plan) and is rolled over to another plan (receiving plan), the benefit of the employee under the receiving plan is increased by the amount rolled over. However, the distribution has no impact on the required minimum distribution to be made by the receiving plan for the calendar year in which the rollover is received. But, if a required minimum distribution is required to be made by the receiving plan for the following calendar year, the rollover amount must be considered to be part of the employee's benefit under the receiving plan. Consequently, for purposes of determining any required minimum distribution for the calendar year immediately following the calendar year in which the amount rolled over is received by the receiving plan, in the case in which the amount rolled over is received after the last valuation date in the calendar year under the receiving plan, the benefit of the employee as of such valuation date, adjusted in accordance with A-3 of §1.401(a)(9)-5, will be increased by the rollover amount valued as of the date of receipt. For purposes of calculating the benefit under the receiving plan pursuant to the preceding sentence, if the amount rolled over is received by the receiving plan in a different calendar year from the calendar year in which it is distributed by the distributing plan, the amount rolled over is deemed to have been received by the receiving plan in the calendar year in which it was distributed by the distributing plan.

Q-3. In the case of a transfer of an amount of an employee's benefit from one plan (transferor plan) to another plan (transferee plan), are there any special rules for satisfying the required minimum distribution requirement or determining the employee's benefit under the transferor plan?

A-3. (a) In the case of a transfer of an amount of an employee's benefit from one plan to another, the transfer is not treated as a distribution by the transferor plan for purposes of section 401(a)(9). Instead, the benefit of the employee under the transferor plan is decreased by the amount transferred. However, if any portion of an employee's benefit is transferred in a distribution calendar year with respect to that employee, in order to satisfy section 401(a)(9), the transferor plan must determine the amount of the required minimum distribution with respect to that employee for the calendar year of the transfer using the employee's benefit under the transferor plan before the transfer. Additionally, if any portion of an employee's benefit is transferred in the employee's second distribution calendar year but on or before the employee's required beginning date, in order to satisfy section 401(a)(9), the transferor plan must determine the amount of the required minimum distribution requirement for the employee's first distribution calendar year based on the employee's benefit under the transferor plan before the transfer. The transferor plan may satisfy the required minimum distribution requirement for the calendar year of the transfer (and the prior year if applicable) by segregating the amount which must be distributed from the employee's benefit and not transferring that amount. Such amount may be retained by the transferor plan and distributed on or before the date required.

(b) For purposes of determining any required minimum distribution for the calendar year immediately following the calendar year in which the transfer occurs, in the case of a transfer after the last valuation date for the calendar year of the transfer under the transferor plan, the benefit of the employee as of such valuation date, adjusted in accordance with A-3 of §1.401(a)(9)-5, will be decreased by the amount transferred, valued as of the date of the transfer.

Q-4. If an amount of an employee's benefit is transferred from one plan (transferor plan) to another plan (transferee plan), how are the benefit and the required minimum distribution under the transferee plan affected?

A-4. In the case of a transfer from one plan (transferor plan) to another (transferee plan), the general rule is that the bene-

fit of the employee under the transferee plan is increased by the amount transferred. The transfer has no impact on the required minimum distribution to be made by the transferee plan in the calendar year in which the transfer is received. However, if a required minimum distribution is required from the transferee plan for the following calendar year, the transferred amount must be considered to be part of the employee's benefit under the transferee plan. Consequently, for purposes of determining any required minimum distribution for the calendar year immediately following the calendar year in which the transfer occurs, in the case of a transfer after the last valuation date of the transferee plan in the transfer calendar year, the benefit of the employee under the receiving plan valued as of such valuation date, adjusted in accordance with A-3 of §1.401(a)(9)-5, will be increased by the amount transferred valued as of the date of the transfer.

Q-5. How are a spinoff, merger or consolidation (as defined in §1.414(l)-1) treated for purposes of determining an employee's benefit and required minimum distribution under section 401(a)(9)?

A-5. For purposes of determining an employee's benefit and required minimum distribution under section 401(a)(9), a spinoff, a merger, or a consolidation (as defined in §1.414(l)-1) will be treated as a transfer of the benefits of the employees involved. Consequently, the benefit and required minimum distribution of each employee involved under the transferor and transferee plans will be determined in accordance with A-3 and A-4 of this section.

§1.401(a)(9)-8 Special rules.

Q-1. What distribution rules apply if an employee is a participant in more than one plan?

A-1. If an employee is a participant in more than one plan, the plans in which the employee participates are not permitted to be aggregated for purposes of testing whether the distribution requirements of section 401(a)(9) are met. The distribution of the benefit of the employee under each plan must separately meet the requirements of section 401(a)(9). For this purpose, a plan described in section 414(k) is treated as two separate plans, a

defined contribution plan to the extent benefits are based on an individual account and a defined benefit plan with respect to the remaining benefits.

Q-2. If an employee's benefit under a plan is divided into separate accounts (or segregated shares in the case of a defined benefit plan), do the distribution rules in section 401(a)(9) and these regulations apply separately to each separate account (or segregated share)?

A-2. (a) Except as otherwise provided in paragraphs (b) and (c) of this A-2, if an employee's account under a defined contribution plan is divided into separate accounts (or if an employee's benefit under a defined benefit plan is divided into segregated shares in the case of a defined benefit plan) under the plan, the separate accounts (or segregated shares) will be aggregated for purposes of satisfying the rules in section 401(a)(9). Thus, except as otherwise provided in paragraphs (b) and (c) of this A-2, all separate accounts, including a separate account for nondeductible employee contributions (under section 72(d)(2)) or for qualified voluntary employee contributions (as defined in section 219(e)), will be aggregated for purposes of section 401(a)(9).

(b) If, for lifetime distributions, as of an employee's required beginning date (or the beginning of any distribution calendar year beginning after the employee's required beginning date), or in the case of distributions under section 401(a)(9)(B)(ii) or (iii) and (iv), as of the end of the year following the year containing the employee's (or spouse's, where applicable) date of death, the beneficiaries with respect to a separate account (or segregated share in the case of a defined benefit plan) under the plan differ from the beneficiaries with respect to the other separate accounts (or segregated shares) of the employee under the plan, such separate account (or segregated share) under the plan need not be aggregated with other separate accounts (or segregated shares) under the plan in order to determine whether the distributions from such separate account (or segregated share) under the plan satisfy section 401(a)(9). Instead, the rules in section 401(a)(9) may separately apply to such separate account (or segregated share) under the plan. For example, if, in the case of a distribution described in section 401(a)(9)(B)(iii) and

(iv), the only beneficiary of a separate account (or segregated share) under the plan is the employee's surviving spouse, and beneficiaries other than the surviving spouse are designated with respect to the other separate accounts of the employee, distribution of the spouse's separate account (or segregated share) under the plan need not commence until the date determined under the first sentence in A-3(b) of §1.401(a)(9)-3, even if distribution of the other separate accounts (or segregated shares) under the plan must commence at an earlier date. In the case of a distribution after the death of an employee to which section 401(a)(9)(B)(i) does not apply, distribution from a separate account (or segregated share) of an employee may be made over a beneficiary's life expectancy in accordance with section 401(a)(9)(B)(iii) and (iv) even though distributions from other separate accounts (or segregated shares) under the plan with different beneficiaries are being made in accordance with the five-year rule in section 401(a)(9)(B)(ii).

(c) A portion of an employee's account balance under a defined contribution plan is permitted to be used to purchase an annuity contract with a remaining amount maintained in the separate account. In that case, the separate account under the plan must be distributed in accordance with §1.401(a)(9)-5 in order to satisfy section 401(a)(9) and the annuity payments under the annuity contract must satisfy §1.401(a)(9)-6 in order to satisfy section 401(a)(9).

Q-3. What is a separate account or segregated share for purposes of section 401(a)(9)?

A-3. (a) For purposes of section 401(a)(9), a separate account in an individual account is a portion of an employee's benefit determined by an acceptable separate accounting including allocating investment gains and losses, and contributions and forfeitures, on a *pro rata* basis in a reasonable and consistent manner between such portion and any other benefits. Further, the amounts of each such portion of the benefit will be separately determined for purposes of determining the amount of the required minimum distribution in accordance with §1.401(a)(9)-5.

(b) A benefit in a defined benefit plan is separated into segregated shares if it con-

sists of separate identifiable components which may be separately distributed.

Q-4. Must a distribution that is required by section 401(a)(9) to be made by the required beginning date to an employee or that is required by section 401(a)(9)(B)(iii) and (iv) to be made by the required time to a designated beneficiary who is a surviving spouse be made notwithstanding the failure of the employee, or spouse where applicable, to consent to a distribution while a benefit is immediately distributable?

A-4. Yes. Section 411(a)(11) and section 417(e) (see §§1.411(a)(11)-1(c)(2) and 1.417(e)-1(c)) require employee and spousal consent to certain distributions of plan benefits while such benefits are immediately distributable. If an employee's normal retirement age is later than the required beginning date for the commencement of distributions under section 401(a)(9) and, therefore, benefits are still immediately distributable, the plan must, nevertheless, distribute plan benefits to the participant (or where applicable, to the spouse) in a manner that satisfies the requirements of section 401(a)(9). Section 401(a)(9) must be satisfied even though the participant (or spouse, where applicable) fails to consent to the distribution. In such a case, the plan may distribute in the form of a qualified joint and survivor annuity (QJSA) or in the form of a qualified preretirement survivor annuity (QPSA) and the consent requirements of sections 411(a)(11) and 417(e) are deemed to be satisfied if the plan has made reasonable efforts to obtain consent from the participant (or spouse if applicable) and if the distribution otherwise meets the requirements of section 417. If, because of section 401(a)(11)(B), the plan is not required to distribute in the form of a QJSA to a participant or a QPSA to a surviving spouse, the plan may distribute the required minimum distribution amount required at the time required to satisfy section 401(a)(9) and the consent requirements of sections 411(a)(11) and 417(e) are deemed to be satisfied if the plan has made reasonable efforts to obtain consent from the participant (or spouse if applicable) and if the distribution otherwise meets the requirements of section 417.

Q-5. Who is an employee's spouse or surviving spouse for purposes of section 401(a)(9)?

A-5. Except as otherwise provided in A-6(a) (in the case of distributions of a portion of an employee's benefit payable to a former spouse of an employee pursuant to a qualified domestic relations order), for purposes of section 401(a)(9), an individual is a spouse or surviving spouse of an employee if such individual is treated as the employee's spouse under applicable state law. In the case of distributions after the death of an employee, for purposes of determining whether, under the life expectancy rule in section 401(a)(9)(B)(iii) and (iv), the provisions of section 401(a)(9)(B)(iv) apply, the spouse of the employee is determined as of the date of death of the employee.

Q-6. In order to satisfy section 401(a)(9), are there any special rules which apply to the distribution of all or a portion of an employee's benefit payable to an alternate payee pursuant to a qualified domestic relations order as defined in section 414(p) (QDRO)?

A-6. (a) A former spouse to whom all or a portion of the employee's benefit is payable pursuant to a QDRO will be treated as a spouse (including a surviving spouse) of the employee for purposes of section 401(a)(9), including the minimum distribution incidental benefit requirement, regardless of whether the QDRO specifically provides that the former spouse is treated as the spouse for purposes of sections 401(a)(11) and 417.

(b)(1) If a QDRO provides that an employee's benefit is to be divided and a portion is to be allocated to an alternate payee, such portion will be treated as a separate account (or segregated share) which separately must satisfy the requirements of section 401(a)(9) and may not be aggregated with other separate accounts (or segregated shares) of the employee for purposes of satisfying section 401(a)(9). Except as otherwise provided in paragraph(b)(2) of this A-6, distribution of such separate account allocated to an alternate payee pursuant to a QDRO must be made in accordance with section 401(a)(9). For example, in general, distribution of such account will satisfy section 401(a)(9)(A) if required minimum distributions from such account during the employee's lifetime begin not later than the employee's required beginning date and the required minimum distribution is determined in accordance with

§1.401(a)(9)-5 for each distribution calendar year using an applicable distribution period determined under A-4 of §1.401(a)(9)-5 using the age of the employee in the distribution calendar year for purposes of using the table in A-4(a)(2) of §1.401(a)(9)-5 if applicable or ages of the employee and spousal alternate payee if their joint life expectancy is longer than the distribution period using that table. The determination of whether distribution from such account after the death of the employee to the alternate payee will be made in accordance with section 401(a)(9)(B)(i) or section 401(a)(9)(B)(ii) or (iii) and (iv) will depend on whether distributions have begun as determined under A-5 or §1.401(a)(9)-2 (which provides, in general, that distributions are not treated as having begun until the employee's required beginning date even though payments may actually have begun before that date). For example, if the alternate payee dies before the employee and distribution of the separate account allocated to the alternate payee pursuant to the QDRO is to be made to the alternate payee's beneficiary, such beneficiary may be treated as a designated beneficiary for purposes of determining the required minimum distribution required from such account after the death of the employee if the beneficiary of the alternate payee is an individual and if such beneficiary is a beneficiary under the plan or specified to or in the plan. Specification in or pursuant to the QDRO will also be treated as specification to the plan.

(2) Distribution of the separate account allocated to an alternate payee pursuant to a QDRO satisfy the requirements of section 401(a)(9)(A)(ii) if such account is to be distributed, beginning not later than the employee's required beginning date, over the life of the alternate payee (or over a period not extending beyond the life expectancy of the alternative payee). Also, if the plan permits the employee to elect whether distribution upon the death of the employee will be made in accordance with the five-year rule in section 401(a)(9)(B)(ii) or the life expectancy rule in section 401(a)(9)(B)(iii) and (iv) pursuant to A-4(c) of §1.401(a)(9)-3, such election is to be made only by the alternate payee for purposes of distributing the separate account allocated to the

alternate payee pursuant to the QDRO. If the alternate payee dies after distribution of the separate account allocated to the alternate payee pursuant to a QDRO has begun (determined under A-5 of §1.401(a)(9)-2) but before the employee dies, distribution of the remaining portion of that portion of the benefit allocated to the alternate payee must be made in accordance with the rules in §1.401(a)(9)-5 or §1.401(a)(9)-6 for distributions during the life of the employee. Only after the death of the employee is the amount of the required minimum distribution determined in accordance with the rules that apply after the death of the employee.

(c) If a QDRO does not provide that an employee's benefit is to be divided but provides that a portion of an employee's benefit (otherwise payable to the employee) is to be paid to an alternate payee, such portion will not be treated as a separate account (or segregated share) of the employee. Instead, such portion will be aggregated with any amount distributed to the employee and will be treated as having been distributed to the employee for purposes of determining whether the required minimum distribution requirement has been satisfied with respect to that employee.

Q-7. Will a plan fail to satisfy section 401(a)(9) where it is not legally permitted to distribute to an alternate payee all or a portion of an employee's benefit payable to an alternate payee pursuant to a QDRO within the period specified in section 414(p)(7)?

A-7. A plan will not fail to satisfy section 401(a)(9) merely because it fails to distribute a required amount during the period in which the issue of whether a domestic relations order is a QDRO is being determined pursuant to section 414(p)(7), provided that the period does not extend beyond the 18-month period described in section 414(p)(7)(E). To the extent that a distribution otherwise required under section 401(a)(9) is not made during this period, this amount and any additional amount accrued during this period will be treated as though it is not vested during the period and any distributions with respect to such amounts must be made under the relevant rules for non-vested benefits described in either A-8 of §1.401(a)(9)-5 or A-6 of §1.401(a)(9)-6.

Q-8. Will a plan fail to satisfy section 401(a)(9) where an individual's distribution from the plan is less than the amount otherwise required to satisfy section 401(a)(9) under §1.401(a)(9)-5 or §1.401(a)(9)-6 because distributions were being paid under an annuity contract issued by a life insurance company in state insurer delinquency proceedings and have been reduced or suspended by reasons of such state proceedings?

A-8. A plan will not fail to satisfy section 401(a)(9) merely because an individual's distribution from the plan is less than the amount otherwise required to satisfy section 401(a)(9) under §1.401(a)(9)-5 or §1.401(a)(9)-6 because distributions were being paid under an annuity contract issued by a life insurance company in state insurer delinquency proceedings and have been reduced or suspended by reasons of such state proceedings. To the extent that a distribution otherwise required under section 401(a)(9) is not made during the state insurer delinquency proceedings, this amount and any additional amount accrued during this period will be treated as though it is not vested during the period and any distributions with respect to such amounts must be made under the relevant rules for nonvested benefits described in either A-8 of §1.401(a)(9)-5 or A-6 of §1.401(a)(9)-6.

Q-9. Will a plan fail to qualify as a pension plan within the meaning of section 401(a) solely because the plan permits distributions to commence to an employee on or after April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2 even though the employee has not retired or attained the normal retirement age under the plan as of the date on which such distributions commence?

A-9. No. A plan will not fail to qualify as a pension plan within the meaning of section 401(a) solely because the plan permits distributions to commence to an employee on or after April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2 even though the employee has not retired or attained the normal retirement age under the plan as of the date on which such distributions commence. This rule applies without regard to whether or not the employee is a 5-percent owner with respect to the plan year ending in the cal-

endar year in which distributions commence.

Q-10. Is the distribution of an annuity contract a distribution for purposes of section 401(a)(9)?

A-10. No. The distribution of an annuity contract is not a distribution for purposes of section 401(a)(9).

Q-11. Will a payment by a plan after the death of an employee fail to be treated as a distribution for purposes of section 401(a)(9) solely because it is made to an estate or a trust?

A-11. A payment by a plan after the death of an employee will not fail to be treated as a distribution for purposes of section 401(a)(9) solely because it is made to an estate or a trust. As a result, the estate or trust which receives a payment from a plan after the death of an employee need not distribute the amount of such payment to the beneficiaries of the estate or trust in accordance with section 401(a)(9)(B). However, pursuant to A-3 of §1.401(a)(9)-4, distribution to the estate must satisfy the five-year rule in section 401(a)(9)(B)(iii) if the distribution to the employee had not begun (as defined in A-6 of §1.401(a)(9)-2) as of the employee's date of death, and pursuant to A-3 of §1.401(a)(9)-4, an estate may not be a designated beneficiary. See A-5 and A-6 of §1.401(a)(9)-4 for provisions under which beneficiaries of a trust with respect to the trust's interest in an employee's benefit are treated as having been designated as beneficiaries of the employee under the plan.

Q-12. Will a plan fail to satisfy section 411 if the plan is amended to eliminate benefit options that do not satisfy section 401(a)(9)?

A-12. Nothing in section 401(a)(9) permits a plan to eliminate for all participants a benefit option that could not otherwise be eliminated pursuant to section 411(d)(6). However, a plan must provide that, notwithstanding any other plan provisions, it will not distribute benefits under any option that does not satisfy section 401(a)(9). See A-3 of §1.401(a)(9)-1. Thus, the plan, notwithstanding section 411(d)(6), must prevent participants from electing benefit options that do not satisfy section 401(a)(9).

Q-13. Is a plan disqualified merely because it pays benefits under a designation made before January 1, 1984, in

accordance with section 242(b)(2) of the Tax Equity and Fiscal Responsibility Act (TEFRA)?

A-13. No. Even though the distribution requirements added by TEFRA were retroactively repealed by the Tax Reform Act of 1984 (TRA of 1984), the transitional election rule in section 242(b) of TEFRA was preserved. Satisfaction of the spousal consent requirements of section 417(a) and (e) (added by the Retirement Equity Act of 1984) will not be considered a revocation of the pre-1984 designation. However, sections 401(a)(11) and 417 must be satisfied with respect to any distribution subject to those sections. The election provided in section 242(b) of TEFRA is hereafter referred to as a section 242(b)(2) election.

Q-14. In the case in which an amount is transferred from one plan (transferor plan) to another plan (transferee plan), may the transferee plan distribute the amount transferred in accordance with a section 242(b)(2) election made under either the transferor plan or under the transferee plan?

A-14. (a) In the case in which an amount is transferred from one plan to another plan, the amount transferred may be distributed in accordance with a section 242(b)(2) election made under the transferor plan if the employee did not elect to have the amount transferred and if the amount transferred is separately accounted for by the transferee plan. However, only the benefit attributable to the amount transferred, plus earnings thereon, may be distributed in accordance with the section 242(b)(2) election made under the transferor plan. If the employee elected to have the amount transferred, the transfer will be treated as a distribution and rollover of the amount transferred for purposes of this section.

(b) In the case in which an amount is transferred from one plan to another plan, the amount transferred may not be distributed in accordance with a section 242(b)(2) election made under the transferee plan. If a section 242(b)(2) election was made under the transferee plan, the amount transferred must be separately accounted for. If the amount transferred is not separately accounted for under the transferee plan, the section 242(b)(2) election under the transferee plan is revoked and section 401(a)(9) will apply

to subsequent distributions by the transferee plan.

(c) A merger, spinoff, or consolidation, as defined in §1.414(l)-1(b), will be treated as a transfer for purposes of the section 242(b)(2) election.

Q-15. If an amount is distributed by one plan (distributing plan) and rolled over into another plan (receiving plan), may the receiving plan distribute the amount rolled over in accordance with a section 242(b)(2) election made under either the distributing plan or the receiving plan?

A-15. No. If an amount is distributed by one plan and rolled over into another plan, the receiving plan must distribute the amount rolled over in accordance with section 401(a)(9) whether or not the employee made a section 242(b)(2) election under the distributing plan. Further, if the amount rolled over was not distributed in accordance with the election, the election under the distributing plan is revoked and section 401(a)(9) will apply to all subsequent distributions by the distributing plan. Finally, if the employee made a section 242(b)(2) election under the receiving plan and such election is still in effect, the amount rolled over must be separately accounted for under the receiving plan and distributed in accordance with section 401(a)(9). If amounts rolled over are not separately accounted for, any section 242(b)(2) election under the receiving plan is revoked and section 401(a)(9) will apply to subsequent distributions by the receiving plan.

Q-16. May a section 242(b)(2) election be revoked after the date by which distributions are required to commence in order to satisfy section 401(a)(9) and this section of the regulations?

A-16. Yes. A section 242(b)(2) election may be revoked after the date by which distributions are required to commence in order to satisfy section 401(a)(9) and this section of the regulations. However, if the section 242(b)(2) election is revoked after the date by which distributions are required to commence in order to satisfy section 401(a)(9) and this section of the regulations and the total amount of the distributions which would have been required to be made prior to the date of the revocation in order to satisfy section 401(a)(9), but for the section 242(b)(2) election, have not been made,

the trust must distribute by the end of the calendar year following the calendar year in which the revocation occurs the total amount not yet distributed which was required to have been distributed to satisfy the requirements of section 401(a)(9) and continue distributions in accordance with such requirements.

Par. 4. Section 1.403(b)-2 is added to read as follows:

§1.403(b)-2 Required minimum distributions from annuity contracts purchased, or custodial accounts or retirement income accounts established, by a section 501(c)(3) organization or a public school.

Q-1. Are section 403(b) contracts subject to the distribution rules provided in section 401(a)(9)?

A-1. (a) Yes. Section 403(b) contracts are subject to the distribution rules provided in section 401(a)(9). For purposes of this section the term *section 403(b) contract* means an annuity contract described in section 403(b)(1), custodial account described in section 403(b)(7), or a retirement income account described in section 403(b)(9).

(b) For purposes of applying the distribution rules in section 401(a)(9), section 403(b) contracts will be treated as individual retirement annuities described in section 408(b) and individual retirement accounts described in section 408(a) (IRAs). Consequently, except as otherwise provided in paragraph (c), the distribution rules in section 401(a)(9) will be applied to section 403(b) contracts in accordance with the provisions in §1.408-8.

(c)(1) The required beginning date for purposes of section 403(b)(9) is April 1, of the calendar year following the later of the calendar year in which the employee attains 70 1/2 or the calendar year in which the employee retires from employment with the employer maintaining the plan. The concept of 5-percent owner has no application in the case of employees of employers described in section 403(b)(1)(A).

(2) The rule in A-5 of §1.408-8 does not apply to section 403(b) contracts. Thus, the surviving spouse of an employee is not permitted to treat a section 403(b) contract of which the spouse is the sole beneficiary as the spouse's own section 403(b) contract.

Q-2. To what benefits under section 403(b) contracts, do the distribution rules provided in section 401(a)(9) apply?

A-2. (a) The distribution rules provided in section 401(a)(9) apply to all benefits under section 403(b) contracts accruing after December 31, 1986 (post-'86 account balance). The distribution rules provided in section 401(a)(9) do not apply to the balance of the account balance under the section 403(b) contract valued as of December 31, 1986, exclusive of subsequent earnings (pre-'87 account balance). Consequently, the post-'86 account balance includes earnings after December 31, 1986, on contributions made before January 1, 1987, in addition to the contributions made after December 31, 1986, and earnings thereon. The issuer or custodian of the section 403(b) contract must keep records that enable it to identify the pre-'87 account balance and subsequent changes as set forth in paragraph (b) of this A-2 and provide such information upon request to the relevant employee or beneficiaries with respect to the contract. If the issuer does not keep such records, the entire account balance will be treated as subject to section 401(a)(9).

(b) In applying the distribution rules in section 401(a)(9), only the post-'86 account balance is used to calculate the required minimum distribution required for a calendar year. The amount of any distribution required to satisfy the required minimum distribution requirement for a calendar year will be treated as being paid from the post-'86 account balance. Any amount distributed in a calendar year in excess of the required minimum distribution requirement for a calendar year will be treated as paid from the pre-'87 account balance. The pre-'87 account balance for the next calendar year will be permanently reduced by the deemed distributions from the account.

(c) The pre-'87 account balance and the post-'86 account balance have no relevance for purposes of determining the amount includible in income under section 72.

Q-3. Must the value of the account balance under a section 403(b) contract as of December 31, 1986, be distributed in accordance with the minimum distribution incidental benefit requirement?

A-3. Distributions of the entire account balance of a section 403(b) con-

tract, including the value of the account balance under the contract or account as of December 31, 1986, must satisfy the minimum distribution incidental benefit requirement. However, distributions attributable to the value of the account balance under contract or account as of December 31, 1986, is treated as satisfying the minimum distribution incidental benefit requirement if such distributions satisfy the rules in effect as of July 27, 1987, interpreting §1.401-1(b)(1)(i).

Q-4. Is the required minimum distribution from one section 403(b) contract of an employee permitted to be distributed from another section 403(b) contract in order to satisfy section 401(a)(9)?

A-4. Yes. The required minimum distribution must be separately determined for each section 403(b) contract of an employee. However, such amounts may then be totaled and the total distribution taken from any one or more of the individual section 403(b) contracts. However, under this rule, only amounts in section 403(b) contracts that an individual holds as an employee may be aggregated. Amounts in section 403(b) contracts that an individual holds as a beneficiary of the same decedent may be aggregated, but such amounts may not be aggregated with amounts held in section 403(b) contracts that the individual holds as the employee or as the beneficiary of another decedent. Distributions from section 403(b) contracts or accounts will not satisfy the distribution requirements from IRAs, nor will distributions from IRAs satisfy the distribution requirements from section 403(b) contracts or accounts.

Par. 5. Section 1.408-8 is added to read as follows:

§1.408-8 Distribution requirements for individual retirement plans.

The following questions and answers relate to the distribution rules for IRAs provided in sections 408(a)(6) and 408(b)(3).

Q-1. Are individual retirement plans (IRAs) subject to the distribution rules provided in section 401(a)(9) and §§1.401(a)(9)-1 through 1.401(a)(9)-8 for qualified plans?

A-1. (a) Yes. Except as otherwise provided in this section, IRAs are subject to the required minimum distribution rules

provided in section 401(a)(9) and §§1.401(a)(9)-1 through 1.401(a)(9)-8 for qualified plans. For example, whether the five year rule or the life expectancy rule applies to distribution after death occurring before the IRA owner's required beginning date will be determined in accordance with §1.401(a)(9)-3, the rules of §1.401(a)(9)-4 apply for purposes of determining an IRA owner's designated beneficiary, the amount of the required minimum distribution required for each calendar year from an individual account will be determined in accordance with §1.401(a)(9)-5, and whether annuity payments from an individual retirement annuity satisfy section 401(a)(9) will be determined under §1.401(a)(9)-6. For this purpose the term *IRA* means an individual retirement account or annuity described in section 408(a) or (b).

(b) For purposes of applying the required minimum distribution rules in §§1.401(a)(9)-1 through 1.401(a)(9)-8 for qualified plans, the IRA trustee, custodian, or issuer is treated as the plan administrator, and the IRA owner is substituted for the employee.

Q-2. Are employer contributions under a simplified employee pension (defined in section 408(k)) or a SIMPLE IRA (defined in section 408(p)) treated as contributions to an IRA?

A-2. Yes. IRAs that receive employer contributions under a simplified employee pension (defined in section 408(k)) or a SIMPLE plan (defined in section 408(p)) are treated as IRAs for purposes of section 401(a) and are, therefore, subject to the distribution rules in this section.

Q-3. In the case of distributions from an IRA, what does the term *required beginning date* mean?

A-3. In the case of distributions from an IRA, the term *required beginning date* means April 1 of the calendar year following the calendar year in which the individual attains age 70 1/2.

Q-4. When is the amount of a distribution from a IRA not eligible for rollover because the amount is a required minimum distribution?

A-4. The amount of a distribution that is a required minimum distribution from an IRA and thus not eligible for rollover is determined in the same manner as provided in Q&A-7 of §1.402(c)-2 for distributions from qualified plans. For example,

if a required minimum distribution is required for a calendar year, the amounts distributed during a calendar year from an IRA are treated as required minimum distributions under section 401(a)(9) to the extent that the total required minimum distribution for the year under section 401(a)(9) for that IRA has not been satisfied. This requirement may be satisfied by a distribution from the IRA or, as permitted under A-9 of this section, from another IRA.

Q-5. May an individual's surviving spouse elect to treat such spouse's entire interest as a beneficiary in an individual's IRA upon the death of the individual (or the remaining part of such interest if distribution to the spouse has commenced) as the spouse's own account?

A-5. (a) The surviving spouse of an individual may elect in the manner described in paragraph (b) of this A-5 to treat the spouse's entire interest as a beneficiary in an individual's IRA (or the remaining part of such interest if distribution thereof has commenced to the spouse) as the spouse's own IRA. This election is permitted to be made at any time after the distribution of the required minimum amount for the account for the calendar year containing the individual's date of death. In order to make this election, the spouse must be the sole beneficiary of the IRA and have an unlimited right to withdrawal amounts from the IRA. This requirement is not satisfied if a trust is named as beneficiary of the IRA even if the spouse is the sole beneficiary of the trust. If the surviving spouse makes such an election, the surviving spouse's interest in the IRA would then be subject to the distribution requirements of section 401(a)(9)(A) applicable to the spouse as the IRA owner rather than those of section 401(a)(9)(B) applicable to the surviving spouse as the decedent IRA owner's beneficiary. Thus, the required minimum distribution for the year of the election and each subsequent year would be determined under section 401(a)(9)(A) with the spouse as IRA owner and not section 401(a)(9)(B).

(b) The election described in paragraph (a) of this A-5 is made by the surviving spouse redesignating the account as the account in the name of the surviving spouse as IRA owner rather than as beneficiary. Alternatively, a surviving spouse

eligible to make the election is deemed to have made the election if, at any time, either of the following occurs:

(1) Any required amounts in the account (including any amounts that have been rolled over or transferred, in accordance with the requirements of section 408(d)(3)(A)(i), into an individual retirement account or individual retirement annuity for the benefit of such surviving spouse) have not been distributed within the appropriate time period applicable to the surviving spouse as beneficiary under section 401(a)(9)(B); or

(2) Any additional amounts are contributed to the account (or to the account or annuity to which the surviving spouse has rolled such amounts over, as described in (1) above) which are subject, or deemed to be subject, to the distribution requirements of section 401(a)(9)(A).

(c) The result of an election described in paragraph (b) of this A-5 is that the surviving spouse shall then be considered the IRA owner for whose benefit the trust is maintained for all purposes under the Code (e.g., section 72(t)).

Q-6. How is the benefit determined for purposes of calculating the required minimum distribution from an IRA?

A-6. For purposes of determining the required minimum distribution required to be made from an IRA in any calendar year, the account balance of the IRA as of December 31 of the calendar year immediately preceding the calendar year for which distributions are being made will be substituted in A-3 of §1.401(a)(9)-5 for the account of the employee. The account balance as of December 31 of such calendar year is the value of the IRA upon close of business on such December 31. However, for purposes of determining the required minimum distribution for the second distribution calendar year for an individual, the account balance as of December 31 of such calendar year must be reduced by any distribution (as described in A-3(c)(2) of §1.401(a)(9)-5) made to satisfy the required minimum distribution requirements for the individual's first distribution calendar year after such date.

Q-7. What rules apply in the case of a rollover to an IRA of an amount distributed by a qualified plan or another IRA?

A-7. If the surviving spouse of an employee rolls over a distribution from a

qualified plan, such surviving spouse may elect to treat the IRA as the spouse's own IRA in accordance with the provisions in A-5 of this section. In the event of any other rollover to an IRA of an amount distributed by a qualified plan or another IRA, the rules in §1.401(a)(9)-3 will apply for purposes of determining the account balance for the receiving IRA and the required minimum distribution from the receiving IRA. However, because the value of the account balance is determined as of December 31 of the year preceding the year for which the required minimum distribution is being determined and not as of a valuation date in the preceding year, the account balance of the receiving IRA need not be adjusted for the amount received as provided in A-2 of §1.401(a)(9)-7 in order to determine the required minimum distribution for the calendar year following the calendar year in which the amount rolled over is received, unless the amount received is deemed to have been received in the immediately preceding year, pursuant to A-2 of §1.401(a)(9)-7. In that case, for purposes of determining the required minimum distribution for the calendar year in which such amount is actually received, the account balance of the receiving IRA as of December 31 of the preceding year must be adjusted by the amount received in accordance with A-2 of §1.401(a)(9)-7.

Q-8. What rules apply in the case of a transfer from one IRA to another?

A-8. In the case of a transfer from one IRA to another IRA, the rules in A-3 or A-4 of §1.401(a)(9)-7 will apply for purposes of determining the account balance of, and the required minimum distribution from, the IRAs involved. Thus, the transferor IRA must distribute in the year of the transfer any amount required determined without regard to the transfer. For purposes of determining the account balance of the transferee IRA and the transferor IRA, the account balance need not be adjusted for the amount transferred as provided in A-4 of §1.401(a)(9)-7 in order to calculate the required minimum distribution for the calendar year following the calendar year of the transfer, because the account balance is determined as of December 31 of the calendar year immediately preceding the calendar year for which the required

minimum distribution is being determined.

Q-9. Is the required minimum distribution from one IRA of an owner permitted to be distributed from another IRA in order to satisfy section 401(a)(9)?

A-9. Yes. The required minimum distribution must be calculated separately for each IRA. However, such amounts may then be totaled and the total distribution taken from any one or more of the individual IRAs. However, under this rule, only amounts in IRAs that an individual holds as the IRA owner may be aggregated. Amounts in IRAs that an individual holds as a beneficiary of the same decedent may be aggregated, but such amounts may not be aggregated with amounts held in IRAs that the individual holds as the IRA owner or as the beneficiary of another decedent. Distributions from section 403(b) contracts or accounts will not satisfy the distribution requirements from IRAs, nor will distributions from IRAs satisfy the distribution requirements from section 403(b) contracts or accounts. Distributions from Roth IRAs (defined in section 408A) will not satisfy the distribution requirements applicable to IRAs or section 403(b) accounts or contracts and distributions from IRAs or section 403(b) contracts or accounts will not satisfy the distribution requirements from Roth IRAs.

Q-10. Is the trustee, custodian, or issuer of an IRA required to report the amount that is required to be distributed from that IRA?

A-10. Yes. The trustee, custodian, or issuer of an IRA is required to report to the Internal Revenue Service and to the IRA owner the amount required to be distributed from the IRA for each calendar year at the time and in the manner prescribed in the instructions to the applicable Federal tax forms, as well as any additional information as required by such forms or such instructions.

PART 54 — PENSION EXCISE TAXES

Par. 6. The authority citation for part 54 is amended by adding the following citation to read as follows:

Authority: 26 U.S.C. 7805 ***

§54.4974-2 is also issued under 26 U.S.C. 4974.

Par. 7. Section after §54.4974-2 is added to read as follows:

Q-1. Is any tax imposed on a payee under any qualified retirement plan or any eligible deferred compensation plan (as defined in section 457(b)) to whom an amount is required to be distributed for a taxable year if the amount distributed during the taxable year is less than the required minimum distribution?

A-1. Yes. If the amount distributed to a payee under any qualified retirement plan or any eligible deferred compensation plan (as defined in section 457(b)) for a calendar year is less than the required minimum distribution for such year, an excise tax is imposed on such payee under section 4974 for the taxable year beginning with or within the calendar year during which the amount is required to be distributed. The tax is equal to 50 percent of the amount by which such required minimum distribution exceeds the actual amount distributed during the calendar year. Section 4974 provides that this tax shall be paid by the payee. For purposes of section 4974, the term *required minimum distribution* means the required minimum distribution amount required to be distributed pursuant to section 401(a)(9), 403(b)(10), 408(a)(6), 408(b)(3), or 457(d)(2), as the case may be, and the regulations thereunder. Except as otherwise provided in Q&A-6, the required minimum distribution for a calendar year is the required minimum distribution amount required to be distributed during the calendar year. Q&A-7 provides a special rule for amounts required to be distributed by an employee's (or individual's) required beginning date.

Q-2. For purposes of section 4974, what is a qualified retirement plan?

A-2. For purposes of section 4974, each of the following is a qualified retirement plan - -

(a) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);

(b) An annuity plan described in section 403(a);

(c) An annuity contract, custodial account, or retirement income account described in section 403(b);

(d) An individual retirement account described in section 408(a);

(e) An individual retirement annuity described in section 408(b); or

(f) Any other plan, contract, account, or annuity that, at any time, has been treated as a plan, account, or annuity described in (a) through (e) of this A-2, whether or not such plan, contract, account, or annuity currently satisfies the applicable requirements for such treatment.

Q-3. If a payee's interest under a qualified retirement plan is in the form of an individual account, how is the required minimum distribution for a given calendar year determined for purposes of section 4974?

A-3. (a) *General rule.* If a payee's interest under a qualified retirement plan is in the form of an individual account and distribution of such account is not being made under an annuity contract purchased in accordance with A-4 of §1.401(a)(9)-6, the amount of the required minimum distribution for any calendar year for purposes of section 4974 is the required minimum distribution amount required to be distributed for such calendar year in order to satisfy the required minimum distribution requirements in §1.401(a)(9)-5 as provided in the following (whichever is applicable) - -

(1) Section 401(a)(9) and §§1.401(a)(9)-1 through 1.401(a)(9)-8 (in the case of a plan described in section 401(a) which includes a trust exempt under section 501(a) or an annuity plan described in section 403(a));

(2) Section 403(b)(10) and §1.403(b)-2 (in the case of an annuity contract, custodial account, or retirement income account described in section 403(b)); or

(3) Section 408(a)(6) or (b)(3) and §1.408-8 (in the case of an individual retirement account or annuity described in section 408(a) or (b)).

(b) *Default provisions.* Unless otherwise provided under the qualified retirement plan (or, if applicable, the governing instrument of the qualified retirement plan), the default provisions in A-4(a) of §1.401(a)(9)-3 apply in determining the required minimum distribution for purposes of section 4974.

(c) *Five-year rule.* If the five-year rule in section 401(a)(9)(B)(ii) applies to the distribution to a payee, no amount is required to be distributed for any calendar year to satisfy the applicable enumerated section in paragraph (a) of this A-3 until the calendar year which contains the date five years after the date of the employee's death. For the calendar year which con-

tains the date five years after the employee's death, the required minimum distribution amount required to be distributed to satisfy the applicable enumerated section is the payee's entire remaining interest in the qualified retirement plan.

Q-4. If a payee's interest in a qualified retirement plan is being distributed in the form of an annuity, how is the amount of the required minimum distribution determined for purposes of section 4974?

A-4. If a payee's interest in a qualified retirement plan is being distributed in the form of an annuity (either directly from the plan, in the case of a defined benefit plan, or under an annuity contract purchased from an insurance company), the amount of the required minimum distribution for purposes of section 4974 will be determined as follows:

(a) *Permissible annuity distribution option.* A permissible annuity distribution option is an annuity contract (or, in the case of annuity distributions from a defined benefit plan, a distribution option) which specifically provides for distributions which, if made as provided, would for every calendar year equal or exceed the required minimum distribution amount required to be distributed to satisfy the applicable section enumerated in paragraph (a) of A-2 of this section for every calendar year. If the annuity contract (or, in the case of annuity distributions from a defined benefit plan, a distribution option) under which distributions to the payee are being made is a permissible annuity distribution option, the required minimum distribution for a given calendar year will equal the amount which the annuity contract (or distribution option) provides is to be distributed for that calendar year.

(b) *Impermissible annuity distribution option.* An impermissible annuity distribution option is an annuity contract (or, in the case of annuity distributions from a defined benefit plan, a distribution option) under which distributions to the payee are being made that specifically provides for distributions which, if made as provided, would for any calendar year be less than the required minimum distribution amount required to be distributed to satisfy the applicable section enumerated in paragraph (a) of A-3 of this section. If the annuity contract (or, in the case of annuity distributions from a defined benefit plan, the distribution option) under which dis-

tributions to the payee are being made is an impermissible annuity distribution option, the required minimum distribution for each calendar year will be determined as follows:

(1) If the qualified retirement plan under which distributions are being made is a defined benefit plan, the required minimum distribution amount required to be distributed each year will be the amount which would have been distributed under the plan if the distribution option under which distributions to the payee were being made was the following permissible annuity distribution option:

(i) In the case of distributions commencing before the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the permissible annuity distribution option is the joint and survivor annuity option under the plan for the lives of the employee and the designated beneficiary which provides for the greatest level amount payable to the employee determined on an annual basis. If the plan does not provide such an option or there is no designated beneficiary under the impermissible distribution option for purposes of section 401(a)(9), the permissible annuity distribution option is the life annuity option under the plan payable for the life of the employee in level amounts with no survivor benefit.

(ii) In the case of distributions commencing after the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the permissible annuity distribution option is the life annuity option under the plan payable for the life of the designated beneficiary in level amounts. If there is no designated beneficiary, the five-year rule in section 401(a)(9)(B)(ii) applies. See paragraph (b)(3) of this A-4. The determination of whether or not there is a designated beneficiary and the determination of which designated beneficiary's life is to be used in the case of multiple beneficiaries will be made in accordance with §1.401(a)(9)-4 and A-7 of §1.401(a)(9)-5. If the defined benefit plan does not provide for distribution in the form of the applicable permissible distribution option, the required minimum distribution for each calendar year

will be an amount as determined by the Commissioner.

(2) If the qualified retirement plan under which distributions are being made is a defined contribution plan and the impermissible annuity distribution option is an annuity contract purchased from an insurance company, the required minimum distribution amount required to be distributed each year will be the amount which would have been distributed in the form of an annuity contract under the permissible annuity distribution option under the plan determined in accordance with paragraph (b)(1) of this A-4 for defined benefit plans. If the defined contribution plan does not provide the applicable permissible annuity distribution option, the required minimum distribution for each calendar year will be the amount which would have been distributed under an annuity described below in paragraph (b)(2)(i) or (ii) of this A-4 purchased with the employee's or individual's account used to purchase the annuity contract which is the impermissible annuity distribution option.

(i) In the case of distributions commencing before the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the annuity is a joint and survivor annuity for the lives of the employee and the designated beneficiary which provides level annual payments and which would have been a permissible annuity distribution option. However, the amount of the periodic payment which would have been payable to the survivor will be the applicable percentage under the table in A-2(b) of §1.401(a)(9)-6 of the amount of the periodic payment which would have been payable to the employee or individual. If there is no designated beneficiary under the impermissible distribution option for purposes of section 401(a)(9), the annuity is a life annuity for the life of the employee with no survivor benefit which provides level annual payments and which would have been a permissible annuity distribution option.

(ii) In the case of a distribution commencing after the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the annuity option is a life annuity for the life of the

designated beneficiary which provides level annual payments and which would have been permissible annuity distribution option. If there is no designated beneficiary, the five-year rule in section 401(a)(9)(B)(ii) applies. See paragraph (b)(3) of this A-4. The amount of the payments under the annuity contract will be determined using the interest rate and actuarial tables prescribed under section 7520 determined using the date determined under A-3 of §1.401(a)(9)-3 when distributions are required to commence and using the age of the beneficiary as of the beneficiary's birthday in the calendar year that contains that date. The determination of whether or not there is a designated beneficiary and the determination of which designated beneficiary's life is to be used in the case of multiple beneficiaries will be made in accordance with §1.401(a)(9)-3 and A-7 of §1.401(a)(9)-5.

(3) If the five-year rule in section 401(a)(9)(B)(ii) applies to the distribution to the payee under the contract (or distribution option), no amount is required to be distributed to satisfy the applicable enumerated section in paragraph (a) of this A-4 until the calendar year which contains the date five years after the date of the employee's death. For the calendar year which contains the date five years after the employee's death, the required minimum distribution amount required to be distributed to satisfy the applicable enumerated section is the payee's entire remaining interest in the annuity contract (or under the plan in the case of distributions from a defined benefit plan).

Q-5. If there is any remaining benefit with respect to an employee (or IRA owner) after any calendar year in which the entire remaining benefit is required to be distributed under section 401(a)(9), what is the amount of the required minimum distribution for each calendar year subsequent to such calendar year?

A-5. If there is any remaining benefit with respect to an employee (or IRA owner) after the calendar year in which the entire remaining benefit is required to be distributed, the required minimum distribution for each calendar year subsequent to such calendar year is the entire remaining benefit.

Q-6. If a payee has an interest under an eligible deferred compensation plan (as

defined in section 457(b)), how is the required minimum distribution for a given taxable year of the payee determined for purposes of section 4974?

A-6. If a payee has an interest under an eligible deferred compensation plan (as defined in section 457(b)), the required minimum distribution for a given taxable year of the payee determined for purposes of section 4974 is determined under section 457(d).

Q-7. With respect to which calendar year is the excise tax under section 4974 imposed in the case in which the amount not distributed is an amount required to be distributed by April 1 of a calendar year (by the employee's or individual's required beginning date)?

A-7. In the case in which the amount not paid is an amount required to be paid by April 1 of a calendar year, such amount is a required minimum distribution for the previous calendar year, i.e., for the employee's or the individual's first distribution calendar year. However, the excise tax under section 4974 is imposed for the calendar year containing the last day by which the amount is required to be distributed, i.e., the calendar year containing the employee's or individual's required beginning date, even though the preceding calendar year is the calendar year for which the amount is required to be distributed. Pursuant to A-2 of §1.401(a)(9)-5, amounts distributed in the employee's or individual's first distribution calendar year will reduce the amount required to be distributed in the next calendar year by the employee's or individual's required beginning date. There is also a required minimum distribution for the calendar year which contains the employee's or individual's required beginning date. Such distribution is also required to be made during the calendar year which contains the employee's or individual's required beginning date.

Q-8. Are there any circumstances when the excise tax under section 4974 for a taxable year may be waived?

A-8. (a) *Reasonable cause*. The tax under section 4974(a) may be waived if the payee described in section 4974(a) establishes to the satisfaction of the Commissioner the following -

(1) The shortfall described in section 4974(a) in the amount distributed in any

taxable year was due to reasonable error; and

(2) Reasonable steps are being taken to remedy the shortfall.

(b) *Automatic Waiver*. The tax under section 4974 will be automatically waived, unless the Commissioner determines otherwise, if—

(1) The payee described in section 4974(a) is an individual who is the sole beneficiary and whose required minimum distribution amount for a calendar year is determined under the life expectancy rule described in §1.401(a)(9)-3 A-3 in the case of an employee's or individual's death before the employee's or individual's required beginning date; and

(2) The employee's or individual's entire benefit to which that beneficiary is entitled is distributed by the end of the fifth calendar year following the calendar year that contains the employee's or individual's date of death.

Robert E. Wenzel,
*Deputy Commissioner
of Internal Revenue.*

(Filed by the Office of the Federal Register on January 11, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 17, 2001, 66 F.R. 3928)

Change of Address for Submission of Art Valuation Requests

Announcement 2001-22

Rev. Proc. 96-15, 1996-1 C.B. 627, informs taxpayers how to request from the Internal Revenue Service a Statement of Value that can be used to substantiate the value of art for income, estate, or gift tax purposes. Section 10 of Rev. Proc. 96-15 sets forth the address for submission of requests for Statements of Value. The address has been changed, and the new address, effective immediately, is as follows:

Internal Revenue Service, POB 27720
McPherson Station, Washington, DC
20038, Attn: C:AP:AS:ART.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 96-15 is modified.

Rev. Proc. 2001-3, Areas in Which Rulings Will Not be Issued; Correction

Announcement 2001-25

This document contains corrections to Rev. Proc. 2001-3, 2001-1 I.R.B. 111, the annual revised list of those provisions of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Corporate), the Associate Chief Counsel (Financial Institutions & Products), the Associate Chief Counsel (Income Tax & Accounting), the Associate Chief Counsel (Passthroughs & Special Industries), the Associate Chief Counsel (Procedure and Administration), and the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) relating to issues on which the Internal Revenue Service will not issue letter rulings or determination letters. As published in the Internal Revenue Bulletin on January 2, 2001, Rev. Proc. 2001-3 contains errors that may prove to be misleading and are in need of clarification. Accordingly, the below sections of Rev. Proc. 2001-3 are corrected to read as follows:

* * *

SECTION 1.02 * * *

(7) New section 3.01(9), dealing with §115 and income of states, municipalities, etc., is moved from old section 5.09, and a new provision is added to indicate the Service's unwillingness to rule as to whether income of certain state established membership organizations is excluded from gross income.

* * *

SECTION 1.02 * * *

(9) New section 3.01(29) combines old sections 3.01(22)-(24), (26) and (27) (which include type A, B, E and F reorganizations, and § 351 and § 1036 exchanges), adds § 332 liquidations and type C reorganizations, expands the no-rule concerning § 351 to include all asset transfers and expands the no-rule concerning § 1036, eliminates the overlap prohibition (i.e., the Service previously would not rule under any Code section if the transaction is described under both one of the enumerated no-rule sections and a section that is not included in the no-rule provisions), and provides that the

Service will now rule on an entire transaction (not just the narrow significant issue) if there is a significant issue in the transaction.

* * *

SECTION 3.01 * * *

(9) Section 115.—Income of states, municipalities, etc.—Whether the results of transactions pursuant to a plan or arrangement created by state statute a primary objective of which is to enable participants to pay for the costs of a post-secondary education for themselves or a designated beneficiary, including: (i) whether the plan or arrangement, itself, is an entity separate from a state and, if so, how the plan or arrangement is treated for federal tax purposes; and (ii) whether any contract under the plan or arrangement is a debt instrument and, if so, how interest or original issue discount attributable to the contract is treated for federal tax purposes. (Also §§ 61, 163, 1275, 2501, and 7701.)

—Whether the income of membership organizations established by states exclusively to reimburse members for losses arising from workmen's compensation claims is excluded from gross income under § 115.

* * *

SECTION 3.01 * * *

(29) Sections 332, 351, 368(a)(1)(A), (B), (C), (E) and (F), and 1036. Complete Liquidations of Subsidiaries; Transfer to Corporation Controlled by Transferor; Definitions Relating to Corporate Reorganizations; and Stock for Stock of Same Corporation.—Whether a transaction qualifies under § 332, § 351 or § 1036 for nonrecognition treatment, or whether it constitutes a corporate reorganization within the meaning of § 368(a)(1)(A) (including a transaction that qualifies under § 368(a)(1)(A) by reason of § 368(a)(2)(D) or § 368(a)(2)(E)), § 368(a)(1)(B), § 368(a)(1)(C), § 368(a)(1)(E) or § 368(a)(1)(F), and whether various consequences (such as nonrecognition and basis) result from the application of that section, unless the Service determines that there is a significant issue that must be resolved in order to decide those matters. Notwithstanding the foregoing, and to the extent the transaction is not described in another no-rule section: (1) the Service will rule on the entire transaction, and not just the significant issue; and (2) the Service will rule on the application of

§ 351 to a controlled corporation when the transaction is undertaken prior to the distribution of the stock of the controlled corporation in a transaction qualifying under § 355.

SIGNIFICANT ISSUE: A significant issue is an issue of law that meets the three following tests: (1) the issue is not clearly and adequately addressed by a statute, regulation, decision of a court, tax treaty, revenue ruling, revenue procedure, notice, or other authority published in the Internal Revenue Bulletin; (2) the resolution of the issue is not essentially free from doubt; and (3) the issue is legally significant and germane to determining the major tax consequences of the transaction.

OBTAINING A RULING: To obtain a ruling on a transaction involving a significant issue, the taxpayer must in its ruling request explain the significance of the issue, set forth the authorities most closely related to the issue, and explain why the issue is not resolved by these authorities.

As a pilot program to better serve taxpayers the No-Rule for §§ 368(a)(1) (A), (B), (C), (E) and (F), and §§ 332, 351 and 1036 were combined, simplified and expanded. Our objective is to encourage taxpayers to seek rulings on transactions involving these provisions where there are significant issues that are not essentially free from doubt, and to prevent expending limited Service resources on the tax consequences of transactions that are clear under controlling authorities. In addition, the Service will now rule on an entire transaction if there is a significant issue, and the Service eliminated the overlap provision which prohibited the Service from issuing rulings under any Code section if the transaction qualifies under both one of the sections listed in this revenue procedure and under a section not listed in this revenue procedure.

* * *

FOR FURTHER INFORMATION CONTACT: Michael Danbury of the Office of Associate Chief Counsel (Corporate) at (202) 622-7978 (not a toll-free number).

Guidance Under Section 355(d); Recognition of Gain on Certain Distributions of Stock or Securities; Corrections

Announcement 2001-26

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Corrections to final regulations.

SUMMARY: This document contains corrections to final regulations (T.D. 8913, 2001-3, I.R.B. 300) that were published in the **Federal Register** on Wednesday, December 20, 2000 (65 F.R. 79719), providing guidance relating to section 355(d), and recognition of gain on certain distributions of stock and securities.

DATES: This correction is effective December 20, 2000.

FOR FURTHER INFORMATION CONTACT: Michael N. Kaibni (202) 622-7550 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of these corrections are under section 355 of the Internal Revenue Code.

Need for Correction

As published, final regulations (T.D. 8913) contains errors that may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the publication of the final regulations (T.D. 8913), which were the subject of FR Doc. 00-32041, is corrected as follows:

1. On page 79721, column 2, in the preamble under the heading "*Transferred With Respect to an Active Trade or Business*," line 11 from the bottom of the paragraph, the language "§1.355-6(d)(3)(iv)(4)(E), the final" is corrected to read "§1.355-6(d)(3)(iv)(E), the final".

2. On page 79722, column 1, in the preamble, under the heading "Options", the second paragraph, line 5, the language "rights, and national principal contracts." is corrected to read "rights, and notional principal contracts.".

§1.355-6 [Corrected]

3. On page 79733, column 3, §1.355-6(e)(3)(i), line 19, the language "only to exchanges that are not treated" is corrected to read "only to exchanges that are not".

Cynthia E. Grigsby,
Chief, Regulations Unit,
Office of Special Counsel
(*Modernization & Strategic Planning*).

(Filed by the Office of the Federal Register on February 5, 2001, 8:45 a.m., and published in the issue of the Federal Register for February 6, 2001, 66 F.R. 9034)

Stock Transfer Rules: Supplemental Rules

Announcement 2001-27

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking.

SUMMARY: This document withdraws proposed regulations (REG-116048-99, 2000-6 I.R.B. 584) relating to an election available to certain taxpayers under section 367(b). The withdrawal corresponds to the upcoming expiration of the availability of the election.

FOR FURTHER INFORMATION CONTACT: Mark Harris at (202) 622-3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On January 24, 2000, the IRS and Treasury published in the **Federal Register** proposed regulations (65 FR 3629) (the proposed regulations), temporary regulations (65 FR 3586) (the temporary regulations), and final regulations (65 FR 3589) (the final regulations) under section 367(b) of the Internal Revenue Code. The proposed and temporary regulations provide a modified version of an election contained in the proposed section 367(b) regulations issued on August 26, 1991 (1991 proposed regulations), which was not adopted in the final regulations. This election allows certain taxpayers to recognize the gain (but not the loss) realized in certain section 367(b) exchanges, rather than including the all earnings and profits amount in income. The preamble to the final regulations explains the reasons for not including the taxable exchange election in the final regulations (65 FR 3589 at 3592).

The IRS and Treasury issued the proposed and temporary regulations in order to provide taxpayers with an opportunity to comment on the decision not to include the taxable exchange election in the final regulations. Section 1.367(b)-3(b)(4)(ii) of the proposed and temporary regulations provide that the taxable exchange election

is applicable for transactions that occur between February 23, 2000, and February 24, 2001. A public hearing was scheduled for April 20, 2000, and written comments were to be received by April 24, 2000. No one requested to speak at the public hearing, and no comments were submitted. In particular, the IRS and Treasury have not received any comments suggesting revisions to the effective date articulated in §1.367(b)-3(b)(4)(ii). Accordingly, this document withdraws §1.367(b)-3(b)(4) of the proposed regulations published in the **Federal Register** on January 24, 2000 (65 FR 3629).

* * * * *

Withdrawal of Proposed Amendments to the Regulations

Accordingly, under the authority of 26 U.S.C. 7805, proposed amendments to 26 CFR part 1 relating to §1.367(b)-3(b)(4), published January 24, 2000 (65 FR 6329), are withdrawn.

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

(Filed by the Office of the Federal Register on January 10, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 11, 2001, 66 F.R. 2373)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as “rulings”) that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it ap-

plies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the

new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.

E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
FR—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel’s Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.

P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
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T.I.R.—Technical Information Release.
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TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.

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